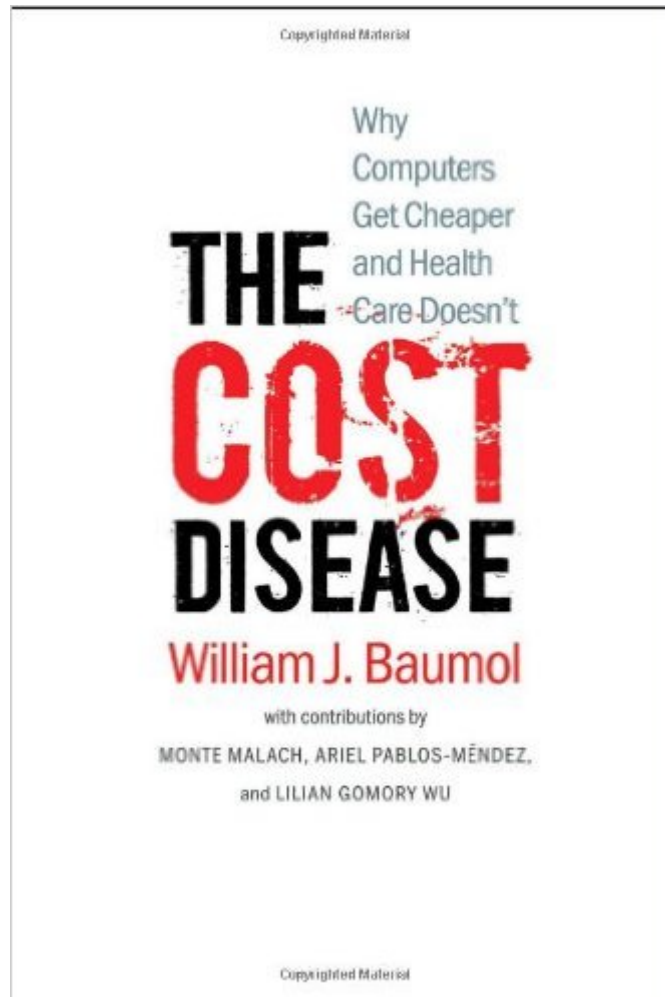


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The Cost Disease: Why Computers Get Cheaper And Health Care Doesn't



Synopsis

The exploding cost of health care in the United States is a source of widespread alarm. Similarly, the upward spiral of college tuition fees is cause for serious concern. In this concise and illuminating book, the well-known economist William J. Baumol explores the causes of these seemingly intractable problems and offers a surprisingly simple explanation. Baumol identifies the "cost disease" as a major source of rapidly rising costs in service sectors of the economy. Once we understand that disease, he explains, effective responses become apparent. Baumol presents his analysis with characteristic clarity, tracing the fast-rising prices of health care and education in the United States and other major industrial nations, then examining the underlying causes, which have to do with the nature of providing labor-intensive services. The news is good, Baumol reassures us, because the nature of the disease is such that society will be able to afford the rising costs.

Book Information

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The basic premise of the book seemed so intriguing. In a nutshell, US healthcare spending is virtually uncontrollable and will go through the roof; but, we will very easily be able to afford those costs. Baumol projects healthcare spending to rise from 15% of US GDP in 2005 to 62% in 2105. But, not to worry because overall we will be over 8 times wealthier as our GDP per capita will rise from \$41,800 to \$343,000. Given that, it will be so easy to spend nearly 2/3 of every dollar on healthcare. However, Baumol's extrapolations 100 years down the road are meaningless if not completely wrong. To understand how he derived his 2105 projections you have to read carefully note 13 on page 187. For healthcare spending as a % of GDP, Baumol observed that they grew by

1.41% per year over the 1995-2005 decade. So, here is how he got the healthcare spending of 62% of GDP: $15\%(1 + 1.41\%)^{100} = 60.8\%$ (I got a different figure because of decimal figures). This same logic suggests that by 2140 or just 35 years later, healthcare will account for 100% of GDP. This does not make any sense. The 62% by 2105 does not make any more sense than the 100% by 2140. Taxes, housing, other consumptions of goods and services, business investments, Government spending can't so readily be squeezed into our remaining 38 cents on the dollar (1 - 62% allocated to healthcare). When it comes to real GDP per capita, Baumol took the 2005 level of \$41,800 and used the 2.13% average annual growth rate in this measure over the 1950 to 2001 period. His calculation: $\$41,800(1 + 2.13\%)^{100} = \$343,000$. Now do you believe that in 2105 we could possibly be over 8 times wealthier than we are currently?

Nearly 50 years ago, William Baumol and William Bowen proposed an economic theory--the "cost disease"--to account for the fact that prices in service industries consistently rise so rapidly relative to the prices of manufactured goods. The cost disease theory rests on the observation that in some industries, especially those that produce goods, "technology has resulted in dramatic increases in productivity, which equate to decreases in the cost per unit of products. Baumol calls these industries the "progressive sector." When the cost to produce a product decreases, then the wages for the workers who produce that product can increase, without any increase in the price of the product. But when that happens, wages also tend to increase in those industries that have not seen productivity increases, the so-called "stagnant sector". Wages must increase there because if they didn't, then those industries would be unable to compete for workers. Since the increased wages in the stagnant sector are not offset by reduced costs of production, prices in that sector grow more quickly than those in the progressive sector. Within the stagnant sector are "high touch" service industries, including health care, education, legal services, and the arts. As Baumol and Bowen noted a half century ago, it still takes five musicians the same amount of time to play a string quintet as it did in the 18th century: technology has not changed that. (In fact, as Baumol notes in the current book, technology has led to some productivity increases even for musicians; for example, by reducing the amount of time it takes them to travel to their concert sites. But any productivity gains in the stagnant sector are very small compared to those in the progressive sector.

Building on his research from 1960s on performing arts, Baumol makes an 'assertion' that cost for personal services like healthcare are "condemned" to significantly outperform overall inflation because the quantity of labor to produce the services cannot be reduced easily. This premise may

have worked (and perhaps still valid) for their early work in performing arts, but translating it to healthcare and education seems too simplified. Comparisons to manufacturing processes is also oftentimes misleading. Such simplifications significantly understate the vast research around modularity, product design, mass customization, and related topics that led to automation in manufacturing and enabled process improvement techniques such as lean sigma. To assume process improvement methods were the main reason for reduced labor involvement in manufacturing is indicative of incomplete analysis. Furthermore, the impact of extraneous factors - malpractice insurance, people's expectation of healthcare delivery and changing patterns of healthcare consumption - have all contributed significantly to cost inflation in healthcare. In fact, earlier on, the authors claim that these factors are minor compared to the nature of labor intensive processes. Most of the arguments tend to be US-centric, and very early on in the book, the authors do acknowledge that policy may be attributable to the significant increases in US healthcare than other countries (notwithstanding an attempt at re-framing the discussion to "rate of increase" - and arguing Japan has a higher rate than US - ignoring the population shifts to elderly may have contributed to that anomaly in Japan).

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