

Hospitals' Rising Overhead Costs Erode Efficiency



When overhead costs climb, hospitals have trouble generating profit, forcing them to raise prices and demand more from health insurers

A report from the Rhode Island Business Group on Health

March 2024

Hospitals in Rhode Island and across the country account for the largest portion of medical expenses driving up the cost of commercial health insurance premiums that Rhode Island's families, businesses, municipalities, unions, and state agencies pay.

Only recently have hospital prices and quality metrics been used to evaluate the value of hospital services. To define this value, the efficiency of the hospital also must be considered along with price and quality. Measuring efficiency requires transparent hospital expense data, including overhead costs, as a critical foundation. Once hospitals get rising overhead costs under control, they can bend the cost curve, benefiting the entire health care system, including hospitals themselves, health insurers, businesses, and consumers.

Identifying Hospital Expenses

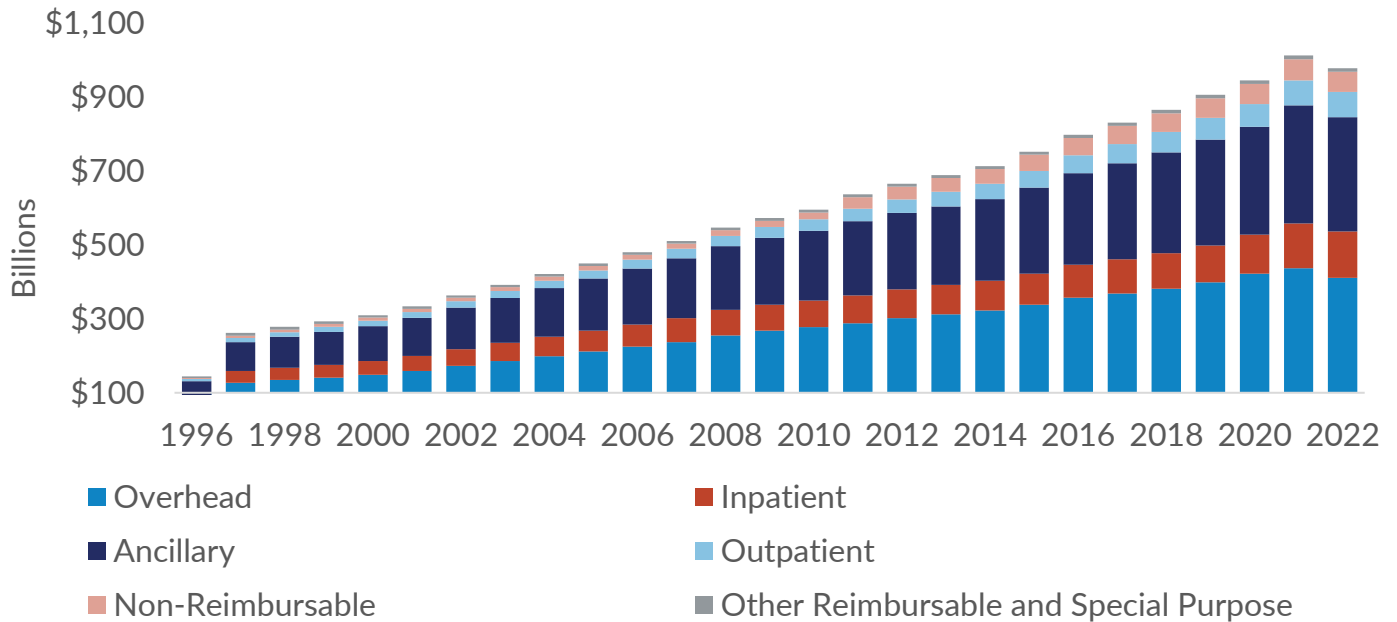
The federal [Medicare Cost Report](#), which hospitals must file annually using general ledger data showing expenses for seven major cost centers, provides detailed longitudinal data. This data is necessary to examine the important factors underlying rising hospital prices over almost three decades.

Exhibit 1 presents a composite view of expenses across the seven major cost centers of U.S. hospitals contained in the Medicare Cost Report from 1996 to 2022. During this 27-year period, total hospital expenses increased by \$834 billion nationally. A substantial 41% (\$342 billion) of this increase went to hospital Overhead,¹ which grew at an annual rate of 7%.

The next three largest categories (Ancillary, Inpatient and Outpatient) totaled \$1 billion, 52% of the \$834 billion increase in hospital expenses over the same period. While all categories experienced percentage growth above the rate of inflation, Non-Reimbursable costs, such as doctors' offices, advertising, and fundraising (which are not directly patient-related), had the highest annual percentage growth rate at 11% per year consuming \$52 billion of the \$834 billion increase in expenses.

¹ The General Service Cost Centers called Overhead by the CMS Office of the Actuary are also known as the non-revenue producing cost centers.

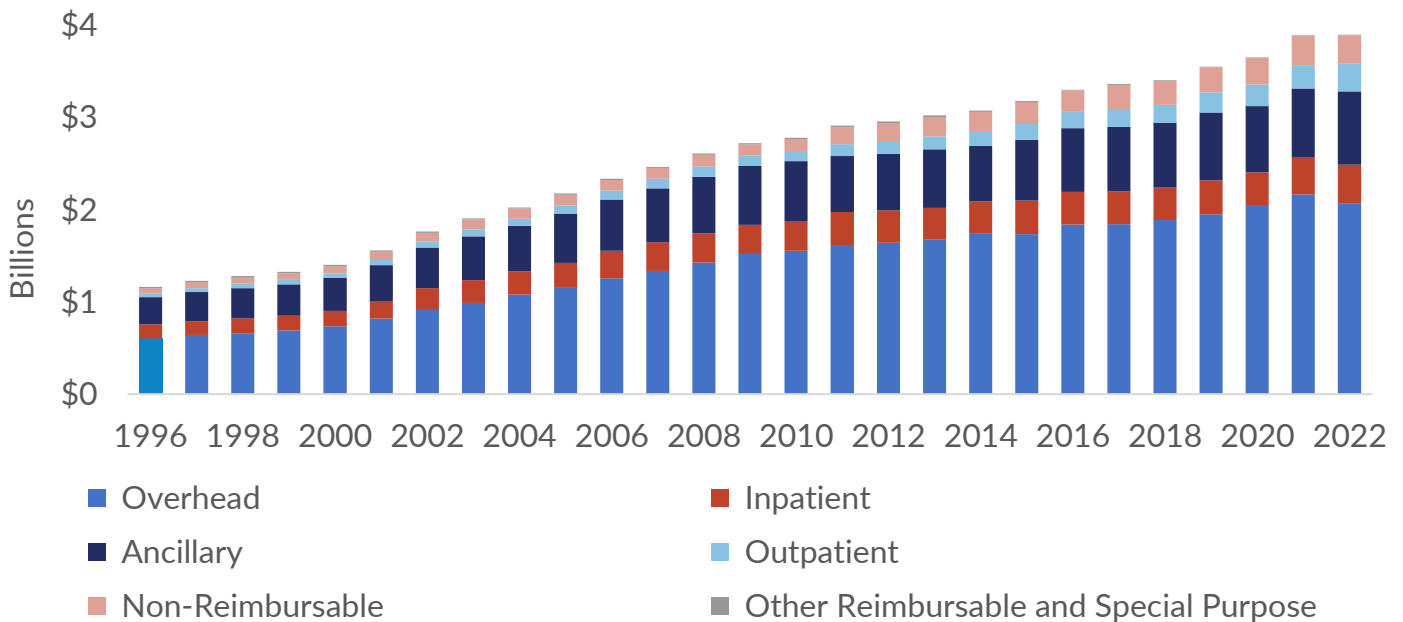
Exhibit 1: U.S. Hospitals Expense Growth, 1996-2022



Source: Medicare Cost Report. <https://www.cms.gov/data-research/statistics-trends-and-reports/cost-reports>

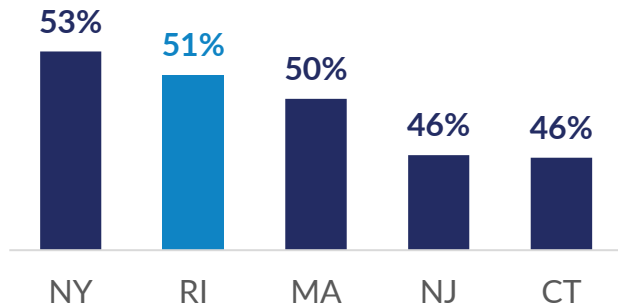
On the state level, Exhibit 2 presents a composite of hospital expenses for facilities in Rhode Island over 27 years. Total hospital expenses increased by \$2.7 billion during this period. The Overhead category consumed 53% of this total expense increase in Rhode Island, substantially more than the national percentage for the same period. The next three largest categories (Ancillary, Inpatient and Outpatient) totaled \$1.3 billion, 38% of the \$2.7 billion increase in hospital expenses over the same years.

Exhibit 2: Trends in Rhode Island Hospitals' Expenses, 1996-2022



Source: Medicare Cost Report. <https://www.cms.gov/data-research/statistics-trends-and-reports/cost-reports>

Exhibit 3: Hospital Overhead as Percentage of Total Expenses



Source: Medicare Cost Report.
<https://www.cms.gov/data-research/statistics-trends-and-reports/cost-reports>

As Exhibit 3 shows, this high overhead expense ratio meant Rhode Island ranked second among all states in 2022 when overhead is expressed as a percentage of total expenses.

Rising hospital overhead expenses have significant consequences for both commercial health insurance premiums and all hospitals themselves. Hospital costs make up nearly 50% of total medical expenses that commercial insurance premiums cover, and overhead is the largest expense category. Increasing overhead costs leads directly to rising premium rates that insurers must charge to cover these hospital expenses.

For all hospitals, higher overhead erodes their ability to generate operating margins. As overhead grows as a percentage of total expenses every year, it becomes increasingly difficult for hospitals to achieve profitability and creates pressure to raise prices continually and seek higher reimbursement rates.

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Rising overhead expenses also raise questions about fiduciary responsibilities and physician practice profitability. The effect of rising overhead costs on hospital profitability begs the question of whether trustees can exercise their fiduciary responsibilities to the organization if unaware of overhead's significant financial impact. Additionally, hospitals in Rhode Island cite losses from physician practices they now own as one of the major reasons for seeking reimbursement increases. This raises the question of whether those losses result from the practices absorbing allocated hospital overhead expenses.

The Importance of Focusing on Overhead

Addressing rising hospital overhead costs requires a multi-faceted approach centered on transparency and measurement. Access to detailed, transparent hospital expense data is necessary for analyzing efficiency and identifying areas for improvement. However, simply having the data is insufficient. A standardized set of efficiency metrics that can be applied consistently across individual hospitals and the industry is critical.

These metrics would not only allow hospitals to benchmark their performance internally over time but would provide visibility into overall industry trends related to efficiency. Such a data-driven approach takes on heightened importance given health policy research showing that hospital consolidation has led to increased costs and potentially compromised quality in some cases.

By promoting expense transparency, adopting robust efficiency measures, and using that information to drive targeted initiatives, hospitals can get rising overhead costs under control and bend the cost curve, which would not only benefit themselves, but also it would benefit insurers, businesses and individuals across the health care system.

RIBGH gratefully acknowledges support of its hospital transparency and payment reform initiative from [Arnold Ventures LLC](#), a philanthropy dedicated to tackling some of the most pressing problems in the United States including high health care costs.

Editor's note: This brief on hospital overhead costs is the second in a series that will provide an analysis toward a potential pathway forward to making health insurance more affordable. The first brief, "[Rhode Island's Ongoing Struggle with Rising Health Care Costs](#)," was published in February and is available at [RIBGH.org](#).