Pro's and Con's of Requiring Health Care Organizations and Insurance Companies to be Nonprofit?

By
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Background

A question has been posed as to whether health care organizations (aka hospitals) and insurance companies should be required to be non-profit.

This is a difficult issue because there is a strong bias in favor of the nonprofit approach. In some other countries that have undergone health care reform, the decision was made to require non-profit status. In considering this question, I propose that we view the topic objectively, based upon data that is generally available, and avoid the perceptual bias that the performance or behavior of a business is driven primarily by how it is financed.

In addressing the capital structure of health care organizations and insurers we need to begin by asking two important questions:

- Why is one form of capitalization and tax status important?
- Is there a demonstrable difference in how organizations perform that is based upon their capital and tax structure?

Capital and Tax Structure

One of the challenges that all organizations face is how they will capitalize themselves so that they can expand, innovate, and bring new products or services to the market. Capital is generally available from three sources: private investment, debt, and public investment. As organizations grow they typically need more capital than can be supported by private investment alone. The next step in the progression is debt. That is because in debt financing the ownership structure of the entity is not impacted. The ability to obtain debt (either in the form of loans or bonds) is limited by the lender's perception of the organization's ability to repay the amounts borrowed. In this context, lenders look at ratio of revenue to current debt, earnings to revenue, etc. to assess the borrower's debt capacity.

However, there is an absolute limit to the amount of debt that is available to borrowers. Once this limit is achieved, organizations sometimes look to an outside investor who provides needed capital in return for stock. Often this involves going to the public market to sell equity.

The advantage of selling stock includes the fact that the markets tend to look more at upside gain in stock value than they do the debt capacity of the borrower. Instead of focusing only on the current financial status of the company, investors look at the opportunity for gain driven by growth and earnings. Investors are thus more risk oriented than lenders.

Capital and Tax Structure (con't)

Why is this discussion relevant? A distinction needs to be made between both the capital and tax structure of organizations since each could drive behaviors.

For profit	Publically traded (outside investors)	Taxable
For profit	Privately held (limited investors)	Taxable
Non-profit	(n/a)	Taxable
Non-profit	(n/a)	Tax-exempt

We have organizations either doing business in or sitused in Colorado that fit all of these profiles. Companies chose one of these structures for a variety of reasons, and can also change structures as their business focus changes, such as the need to invest in additional services. But the most important element for this discussion is to examine the behaviors and outcomes of each organization.

Publically Traded vs. NonProfit

The question then focuses on whether a for profit organization behaves differently than a not-for-profit is really more an issue of whether the company is publically traded, versus any other form, whether private or nonprofit, since all of these latter forms are managed by a limited group. Publically traded companies have the challenge of having to meet quarterly earnings estimates in order to retain their favor with investors. This means that their view of the future is often limited to the next three months, and sometimes this need for immediate positive earnings causes behaviors that conflict with others that might be considered a better long term solution. An example would be the need to reduce staff to maintain earnings, although having fewer staff may impact the productivity or quality of the company's output or service.

It is because of this distinction that I find it useful to clarify the captioned question by addressing publically traded organizations (which are also for-profit) versus simply looking at whether a company's tax status.

Having said this, I would argue that all organizations, for-profit and nonprofit, need to generate an operating margin. Operating margins are needed to cover things like the depreciation on plant and equipment, and to be able to support investments in new initiatives, for expansion, etc. as well as demonstrate capacity to take on new debt. A renowned Catholic nun once issued the prophetic phrase "no margin, no mission." This demonstrates that without a bottom line, even a mission oriented, eleemosynary organization can not survive.

The Evidence

As described above, it is possible that a publically traded company might feel such pressure to meet quarterly earnings targets that it acts in ways that are detrimental to its mission. The press is full of examples of this. Never-the-less, there is little evidence that publically traded health care organizations, or publically traded insurers operate in a way that is generally less efficacious for those they serve.

The Evidence (con't)

In Colorado, the publically traded hospitals have driven significant bottom lines in recent years. However, I would propose that their results have not been widely variant from their nonprofit counterparts. There is also no current evidence that these publically traded institutions have lower patient quality, or less favorable outcomes, overall. In fact, the amount of charity care provided by the publically traded hospitals has historically not been significantly different than that of their nonprofit counterparts.

This challenge has been the very fodder that Senator Grassley has used in Congress to argue that nonprofit hospitals demonstrate why they should retain their not for profit status. It is also one of the reasons why the IRS has recently expanded the annual report (form 990) for nonprofits to demonstrate their community benefit.

Insurers face the same questions. However, there is also no evidence to demonstrate that publically traded insurers have higher insurance rates based on their capital or tax status. One health plan may have lower rates but those may be more to do with how medical services are organized and provided than whether the organization pays income taxes.

Broadening the Scope

Such discussions are traditionally focused almost exclusively on insurers and hospitals. However, if there is a belief that one type of financial structure is necessary to achieve a particular policy outcome, we need to expand the conversation to include the full scope of health care spending in order to have the desired result and in the interest of balance.

The portion of the health care dollar spent on professional services (i.e., those directly provided by physicians and other clinicians) generally exceeds that of hospital services. In addition, the services directly controlled by health care professionals account for almost all medical spending. Therefore, if there is going to be any discussion on financial structure, it must be expanded to all health care services, which include professional, pharmacy, and ancillary (e.g.. dialysis, medical devices, ambulance/EMS, home health, skilled nursing) organizations.

Conclusion

In my view, all of this is to say that focusing on the profits of entities as a way to lower health care costs may not be the best course of action. There may be conceptual or policy reasons to consider the proposal to require health care entities and insurers to be nonprofit. However, let's not assume that being nonprofit means there is any less "profit" generated by these entities nor any more community benefit provided.

While I have concluded by expressing my opinion in the interests of transparency, the remaining comments are based on documented facts comparing performance indicators of the organizations discussed. I hope this paper has been helpful in providing additional perspective for this important discussion.