Lecture Text

Regina E. Herzlinger

Consumer-Driven Health Care: A Revolution for Employers, Consumers, and Providers

(*edited for clarity*)

Introduction

I teach both accounting and health care. And I'm going to be telling you about consumer-driven health care, which is a radical change in health care both in the United States and in other parts of the world. I'm going to tell you about what it is, why it is, how it works, when it's going to happen, which is very soon, where it's going to happen, and the role of the market in making it happen. I'm going to respond to various scare stories about consumer-driven health care. Nobody likes change. I'm going to talk about the role of the government and your role in making it happen.

What Is Consumer-Driven Health Care?

So, what is consumer-driven health care? Well, in the early twentieth century, Henry Ford, who was a genius and a monster—a genius engineer and a monster in other ways, like many entrepreneurs, like many of us—made a rash promise. At the time in the U.K. it cost as much to buy a home as to buy an automobile. And Henry Ford said, "I'm going to make it better and I'm going to make it cheaper." And people said, "You're just crazy." And in some ways, of course, that turned out to be true, but not when it came to construction of the automobile. And in about ten years, due to Ford's genius in making it both better and cheaper—and it wasn't just mass production; he was an incredibly smart engineer and he innovated the design of the car and the manufacturing of steel for the car and made many technological innovations—the ownership of automobiles went up almost a hundred fold because he made it affordable for the middle class.

So, Henry Ford in one way typifies what consumer-driven health care is about, which is to change the health care system and to solve many of the problems, not by rationing and not by saying no to people, but by making it both better and cheaper, by inducing brilliant innovators—like Henry Ford—to get involved with health care.

Henry Ford also illustrates the other side of this story, the non-consumer-driven part of this story. He is alleged to have said, "You can have it in any color as long as it's black." As a researcher, I called the Ford Museum to check whether indeed he said it and they said, "No, he didn't," which I think they say about many of the things that Henry Ford is alleged to have said—he was not exactly politically correct. But whether he said it or not, he meant it, because the thing that enabled General Motors to become so successful is Alfred Sloan. Sloan may have lacked the engineer's entrepreneurial insight into how to make it better and cheaper, but Sloan understood management and he also understood consumers. General Motors was a roll-up of the many automobile manufacturers that existed at the time. He tailored it for consumers' differing needs by creating different brands. By creating the Cadillac versus the Chevrolet, the Buick versus the Oldsmobile, and the Pontiac, Sloan understood what Ford did not, and that is that American consumers, and really consumers in most developed countries, respond to choice.

Enrollee control

So, we are going to have a lot of choice and better, cheaper health care in consumer-driven health care. Right now, in most corporations, consumers have a choice of one insurance

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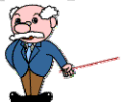

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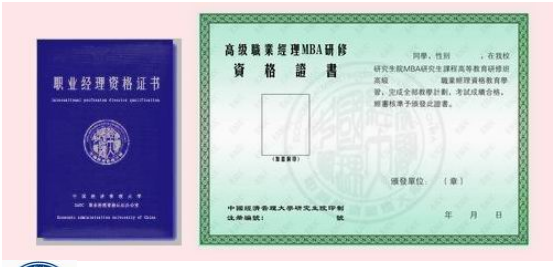

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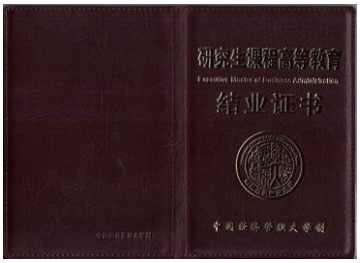

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policy. They have more or less the Model T, but it's not the better, cheaper Model T. And even when they have choice, it's not much of a choice. I have a choice of three or four insurance policies, but as far as I'm concerned, they're virtually identical. The only difference among them is that if I'm willing to pay a little more, I have easier access to my providers, and if I want to pay a little less, I have a harder time accessing my providers. But it doesn't really give me the kind of choice I want.

Choice
What do I want? Well, at my age, I'm tremendously interested in long-term care insurance. This is insurance for nursing homes. The reason I'm interested in it is that the average American woman spends over $100,000 if she winds up in a nursing home. To calibrate what over $100,000 is, the average family income in the United States is $44,000. She may then go bankrupt and wind up on Medicaid. One of the problems with Medicaid is that so many middle class, uninsured people are on Medicaid that they squeeze out the use of Medicaid for the indigent. They become indigent themselves. So, I would like to buy long-term care insurance.

Now, why do I keep referring to women when I describe long-term care insurance? Because right now, most of the people who are in nursing homes are women. It will change with my generation, which I think was the first generation where women, correctly or not, moved in large scale into the labor force. We're going to die at the same age as men for that decision. But right now, if you are a man in a nursing home, prostate condition or not, Alzheimer's or not, you're a hot ticket.

Benefits: Another one of the things that will change is the level of benefits. For example, customized drugs are incredibly effective. More effective, more tailored for you rather than for me, and incredibly expensive. And most of us lack health insurance for those things and probably could not afford them without it.

Coverage: So, we want changes in benefits. I also want changes in coverage. I have a health-insurance policy that covers me from essentially zero dollars to up to a million dollars. I want a health-insurance policy that covers me from about $7,000 up to two or three million dollars. And the reason is that if I'm really sick, I'm going to blow through that million in three seconds. So, I'd like to change my coverage, but I cannot do it. I don't have the possibility of communicating my preferences to my employer.

Term: Another thing that will change with consumer-driven policies is the term of the policy. Term is a financial word meaning the length of the policy. Health insurance is sold in one-year terms. What's the problem with that? Well, what is the incentive for an insurer to invest in making somebody healthier when the benefits of that investment will only materialize four, five, ten years later? In a consumer-driven environment, I can envision that we would have long-term relationships where we're not just dating, we're living together.

Provider payments: Providers also have problems with present insurance policies. Whether you are Ms. TLC or Ms. Icy Hands and Icy Heart, you get paid the same. It's a very strange occupation where true excellence in your craft is not differentiated by the amount of pay that you receive.

Here's another anomaly. In a consumer-driven system, there are differentiations in what we pay: what we pay for cars, what we pay for clothes, what we pay for everything. That will happen in a consumer-driven system as well.

Bundles of Care: There is one last thing that will change, and there is an editorial about it where I analogize, to the dismay of the medical profession, the medical profession to a fish restaurant.[*] The analogy is about "bundles of care." One of the major issues in health care is chronic disease. In fact, you all know about Pareto's Law? Pareto's Law is the 80/20 rule; 80 percent of everything can be explained by 20 percent of the possible causes. For example, go home and look in your closet. Eighty percent of what you wear will come from 20 percent of what's hanging in your closet. As a teacher in a graduate school of business, I know for a fact that 80 percent of the beer in the United States is consumed by about 20 percent of the drinkers, whom I know personally.

So, what does 80/20 have to do with health care? It has a lot to do with health care. One of the ways it affects health care is that 80 percent of health care costs are spent on chronic diseases—cardiovascular disease, cancer, and diabetes. We spend so much money on most of these diseases that they're bigger than big industry, like the aeronautics industry or the agricultural industry. Cardiovascular disease, for example, weighs in at $350 billion. Now, these diseases are chronic diseases. They're long-term diseases and they're incredibly costly. They're also very mismanaged. It is not that the individual providers, doctors, hospitals, nurses, are not excellent. They likely are very excellent. The problem is that they're not integrated and there isn't a system of care for people who have these diseases.

Let me give you an example of an attempt to solve this problem. I have a friend named Ralph Snyderman, who is the CEO of the Duke Medical Center. He's a physician, worked for Genentech, a very statesmanlike and shrewd man. So, Snyderman understands this issue, understands that he should do something to help it. Congestive heart failure essentially means that your heart is failing. If you see people with big balloons around their ankles, they've likely got fluid in their system and their heart is too weak to pump that fluid. These people have to be admitted to the hospital to get that fluid out. They're seriously ill. This disease is a mere minnow in the U.S. health care system, only $52 billion in direct costs. (Give a billion, take a billion; soon you're talking real money.) So, it's $52 billion and Snyderman thinks, "If I can only integrate all the providers for congestive heart failure." One of the problems with congestive heart failure is that it is treated with pills that have unpleasant side effects. The pills help you avoid this congestion. You don't feel great because you took a pill—it just helps you avoid this congestion. So, people don't take the pills.

Snyderman innovated the program, integrated the providers, and helped people take these miserable medications. In one year, he saved $8,600 per person. If we'd done this on a national basis, we would have saved 20 percent of the costs of congestive heart failure. And the way he saved the money was by making people healthier so they didn't go to the hospital as often because they weren't as congested. And they didn't stay for as long a period of time. He didn't do it by saying, "No, you can't go and see the cardiologist," or, "No, you can't go to Duke Medical Center." He did it the way it should be done.

What was his reward? Under the present health insurance system, he lost the entire $8,600 that he saved. The reason he lost it is that he gets paid to run a hospital, and the healthier he makes people, the more money he loses. Now that's a really bizarre artifact of our present payment system. Eighty percent of our health care costs are with chronic diseases that need integrated care. But if you're foolish enough to provide the integrated care and you're a kind of Henry Ford personality—this is Snyderman, it's not some insurer, not that

[*] "Prix-Fixe Rip-Off," *Wall Street Journal* (editorial), June 13, 2003.

insurers aren't wonderful people, but this is a man who really knows how to deliver health care—if you do that innovation, you're going to get screwed.

I have another friend who's the CEO of Rush Presbyterian in Chicago. Chicago is probably the fourth-largest city with AIDS in the United States. And he started a center for the care of AIDS. Same problem. Lots of different providers; very taxing self-care regimen. He integrated the care. The only way he could afford to do the right thing was to raise a multi-million dollar endowment to create this program.

Resulting Choices
So, in a consumer-driven system, we're going to have choice for people like me to choose the benefits. I bet you would want very different things from me; that's how it works in a market. We could choose the benefits, coverage, and term that we want, but providers would also be liberated to name their own price and create their own menu. That's where the analogy with the fish restaurant comes in. If you read this editorial, it's about a restaurant near me called Summer Shack, which is in a kind of downbeat part of Cambridge. And this brilliant chef, Jasper White, started it, and it's a huge restaurant. Maybe some of you remember the Aku Aku in Cambridge. Nobody will ever own up, except for Rick, to having gone there. It was a real dive. I went there. Huge place. Polynesian god in front of it. He took over the Aku Aku, and he started this restaurant in a low-scale part of Cambridge. It's a fish restaurant. Real men don't eat fish. You know, it's a huge, huge gamble. And it became an enormous success. It was a classic entrepreneurial story. Do good; do well. Not only was it a huge success, but it changed the neighborhood and it became a much more diversified neighborhood from what it was.

But as I said in my editorial, if he were a doctor, he couldn't do any of this. He couldn't buy his own place, he couldn't create his own menu, and he couldn't quote his own prices. There are regulatory barriers in front of doctors in doing any of these things.

Information
The last innovation that we're going to have in consumer-driven health care is that you can't have a market, you can't have people shopping, without information. What information do you have in health care? Well, maybe you know how frequently your health plan does mammograms or whether it does an assay for prostate, for benign prostate disease. But do you want to know that? I want to know, if I need a mastectomy, I'm really interested in the quality of my doctor and my hospital, that's what I want to know. I don't have that information. I have it for my panty hose, I have it for my tomato sauce, I have it for my car, but for the thing I really care about, that information is totally lacking. It will appear in a consumer-driven market.

Cost—ever try to find out what anything costs in health care? Totally un-transparent system. Even they don't know what anything costs. That will change in a consumer-driven market because it relies on people's knowledge of quality and cost. There will be a lot of support in a consumer-driven system.

Examples of Consumer-Driven Health Care Innovations
Let me give you some examples to date.

Innovations in benefits and coverage
***Medtronic*:** Medtronic is that great company led by one of your classmates, Bill George, who's MBA '65. Bill George took over the company and raised the market cap from $10

billion to $80 billion while cutting the price of the marvelous devices that Medtronic makes. He was a good CEO. It's important because he was the first mover in consumer-driven health care. And the reason it's important is that in the late 1980s, the country went all managed care. Nobody knew what managed care was. Now, how did they go all managed care? Because in the late 1980s, somebody similar to Bill George adopted all managed care for his company. And the company was AlliedSignal. AlliedSignal was a serious company. The CEO, Larry Bossidy, who's written a best-selling book on management, was well regarded. So, somebody who didn't know an HMO from an ABC or an XYZ said, "What the hell, AlliedSignal's doing it, it must be okay."

Bill George is a similar first mover in the consumer-driven space. So, what did he do? He adopted the offering of an entrepreneurial company named Definity. The Definity policy, if you're an employee of Medtronic and you choose it, has a deductible that ranges from $2,000 to $7,000. Now, why would anybody buy this? Well, here's why they buy it. First, it's cheap as can be, much, much cheaper than you would expect. When you get that high deductible, you're going to get a much lower cost policy. Second, it has a tail of $2 million rather than $1 million. Somebody like me would be very interested. It provides me much more coverage at the end.

Thirdly, it pays for 100 percent of all preventive care. And fourthly, it gives me $2,000 to spend for anything that I want in health care. I don't want to get personal, but among the things you might want to buy is Viagra, you might want to buy batteries for your hearing aid, weight-control classes, whatever. They're all available through Definity. This is an example of different kinds of coverage. United Health just bought Golden Rule, an insurance company that specializes in this. WellPoint, an excellent insurer out in California; Humana, a regional insurer; they all offer these kinds of policies. And they're called consumer-driven policies, but they're really just the beginning.

***Destiny*:** Another kind of policy changes the benefits you receive. Destiny, which is the American arm of a South African company, gives you points for promoting your health. So, if you stop smoking, you get points. If you are morbidly obese, meaning you haven't seen your toes for a long time, and you enroll in a weight control class, you get points. If you take CPR, you get points. What are these points for? Well, you can use the points for vacations; you can use them for airlines. You can also use them to increase the interest rate in the savings account, which is called the health-reimbursement account.

Innovations in term
***Switzerland*:** Switzerland is a marvelous country, neutral in the sea of madness that is Europe. Stayed alive, stayed prosperous with absolutely no assets other than the Alps and cows that give delicious milk for that milk chocolate. Switzerland has had a consumer-driven health care system since the early twentieth century. I'm going to tell you more about this system. In Switzerland, consumers buy their own health insurance and they're universally insured.

So, what are the innovations? What you'd expect in a consumer-driven market is a lot of innovation. One of the innovations they have is a five-year health insurance policy. If at the end of the five years you are healthier than would have been predicted for you in the beginning of the five years, you get 45 percent of your money back. So, that makes it interesting for you and interesting for the insurer for you to be in good health. But because it takes more than one year to reverse your health status, the five-year period is valuable.

Provider innovations
Let me tell you some innovations with providers.

Vivius: One of them is with a Minneapolis firm called Vivius. Vivius used to have a perfectly straightforward name like Health Insurance Select. Went to New York, paid some guy 60,000 bucks, showed up with the name Vivius, which nobody knows what the heck it means. What does Vivius do? Vivius is a Chinese menu. You pick your deductible, you pick your co-pay, you pick the maximum out-of-pocket, and you pick the tail. The providers are free to quote their own prices. You put this all together and if it's more than your employer wants to pay, you start all over again. So, this is a mechanism that empowers the providers to quote their own prices.

BHCAG: BHCAG, here's another name winner: Buyers Health Care Action Group in Minneapolis. Most of these innovations are in Minneapolis. BHCAG is an innovation that completely disintermediates the insurers; there are no insurers involved. There are some twenty-five care teams, and these care team say, "I'll provide all your health care." One of these care teams is the Mayo Clinic. One of them is Park Nicollet, a great hospital in the Minneapolis area. And there are twenty-three others. Your employer gives you enough money to buy the cheapest care team. The cheapest care team happens to be the Mayo Clinic. You then get enough information about how other consumers viewed these different providers and you choose the providers that you want to sign up with.

So, the providers in this innovation are liberated because they can quote their own prices. What else happens? They're risk adjusted. Park Nicollet is world famous for its care of diabetics. An average diabetic costs about $12,000 a year to treat. Park Nicollet, if it were to get paid whatever it quotes and attract all diabetics, is not going to be in business for very long. So, BHCAG risk adjusts. In other words, at the end of some period of time, if a program, a care team, has a disproportionate share of sick people, they get more money. If it attracts a disproportionate share of well people, they get less money. The incentive to cherry-pick a population and just pick the healthy is minimized with this system. Very liberating for providers who aim at the sick. And I'll tell you the results of this in a little while.

Innovations in information
HealthAllies: This is about the innovations in information created by a Harvard MBA '93, Andy Slavitt. What does HealthAllies do? Let me give you a hypothetical case of a woman in Los Angeles who needs her hip repaired. She is uninsured. The largest growing category of uninsured is people who earn over $75,000 a year. Why are they uninsured? Because $75,000 after taxes is $37,500. Average family health-insurance policy costs how much? A ton, yes, $13,000 in the group market. Who knows what it costs in the individual market, $35,000, $13,000, it's not going to happen. She is actually a wealthy person in terms of statistics but she's uninsured. She goes to Cedar Sinai and she says, "I'd like a hip replacement. How much does it cost?" Well, immediately this is a problem because nobody has any idea what it costs and they search around and they come up with a price. Let me say hypothetically the price is $35,000, which she can't afford. Not going to pay that.

She goes to HealthAllies. She says, "I want my hip replaced. I want it in an academic medical center. I want it done by a doctor who does a hundred of these per year. I don't want anybody practicing on my hip. Let them practice on somebody else's hip. I want it thirty miles from my home." And they conduct an auction on her behalf. So, it's "eBay comes to health care." She winds up at Cedar Sinai, but the price is $17,500 because the

hospitals are like the airlines: They're a fixed-cost machine, so the costs are going to be there whether she shows up or not. They may as well discount their prices to attract her.

I have cases on all of these things in my course on *Innovating in Health Care*. It's a second-year course. I have a hundred MBA students in it.

BestDoctors: BestDoctors is another innovation. If you have a rare disease it tells you who the best doctors are, as chosen by their peers, not because they golf with them, not because they go to church with them, but because they know their work. It's done on a nationwide basis, best doctors for that particular disease.

CareCounsel: CareCounsel was started by another one of my students, an MBA with a doctorate in mental health. He was the head of outpatient mental health care for Kaiser. And he provides support for people who are selecting health insurance. They need support in dealing with their insurer and in dealing with their provider. These are examples of what happens.

New Offerings
Here's what's going to happen in consumer-driven health care. Rather than just being offered an HMO or PPO, you'll be offered an HMO, a PPO (a network where you don't have a gatekeeper), high deductible, a multi-year policy, a bundle of disease-focused providers who offer their services for your diabetes, your AIDS, women's health, your bad back, your bad feet, and customized plans a la Vivius. There'll be a lot of information and there'll be a lot of support. These are all existing companies.

Results
Let me give you some results as of today.

BHCAG
BHCAG has had a lower rate of increase than the other plans in the Minneapolis area. When BHCAG started, 70 percent of the enrollees were in high-cost plans. Three years later, 17 percent of the enrollees were in high-cost plans. That's what happens when you have transparency in the system.

Switzerland
Let me tell you what happened in Switzerland. In Switzerland, which has had consumer-driven health care since about 1911, citizens can freely choose from a variety of policies, including high deductible. You have to buy health insurance in Switzerland. If you can't afford it, either the canton or the country will subsidize you in the purchase, but you buy it. They pay for the policies themselves. Providers are as constrained as in the United States; in fact, Swiss physicians belong to a union. In other words, this is an innovation in demand, not an innovation in supply. This is an innovation in how people purchase health care. What are the results in Switzerland? Excellent quality of care. Now, we're always compared with other countries and we come out terrible. One of the reasons is that we're much more diverse and heterogeneous than other countries, so the comparison is totally unfair and meaningless. I compared Switzerland not to the United States as a whole. Because of our diversity, most countries are better in health care than the United States as a whole. I compare them to states that are like Switzerland. Let's say the state of Connecticut or the Commonwealth of Massachusetts. Still the Swiss system was a better system. Excellent resources. In the U.K., there are waiting lists. Nothing like that in Switzerland. Access to care, excellent care, and people come from all over the world to go to Switzerland's health care system.

How much does it cost? Our expenditures are 14 percent of GDP. Swiss health care expenditures, for an excellent system with universal health care, are 10 percent of GDP. So, with the Swiss, the moral of the lesson is that when the system is transparent, when people control purchases, costs go way down, just from that, even without innovations from the Henry Fords of the world.

Mystery Firm
Here is a mystery firm in Texas that has used consumer-driven health care for one year, and even in one year they had overall utilization falling without damaging people who are sick.

The Forces Behind Consumer-Driven Health Care
Now, why is this going to happen? It's going to happen because the same forces that support change of everything else in the United States support this system. One is employers, one is providers, and one is consumers.

Consumers
In the United States, consumers have an enormous amount of choice, control, and information in everything they do. Not in health care. So, when it comes to books, there are about 80,000 titles published every year. When it comes to magazines, there are 800 magazines. When it comes to automobiles, there are 240 models of automobiles. When it comes to health insurance, it's a choice of one, more or less.

Secondly, people have enormous amounts of information about how to do virtually everything. I believe Julia Child kicked off this movement with her treatises on how to make your own pizza, how to eviscerate a chicken, and so on. And it's now come to things like how to do your own heart surgery, how to do your own plumbing. Americans want to know "how to." I own many of these books. I've never read them but I own them, so I'm kind of part of that generation.

Control. Think about the 401(k). 401(k) funds now account for 30 percent of retirement monies. Those are a tremendous shift in control from the old way, the DB way, the defined benefit way, where some expert controlled how your money was invested, to the new way, the defined contribution 401(k) where I control how my money is invested.

How consumers influence productivity
Now, you know, we've had astonishing rates of increase in productivity in the United States and we continue to have astonishing rates of increase in productivity in the United States. It is really a stunning statistic because we're such a huge economy. So, if a little country—Hong Kong, Singapore, Taiwan—has a high rate of increase in productivity, fantastic. But if we have it, that's like an elephant doing a back flip. How did that happen? Well, nobody knows. I think that's why when Greenspan testifies, people say, "What the heck did he say?" And the reason is not that he's not a smart man, but we really don't understand the reasons for the productivity increases in the country.

The great consulting firm McKinsey undertook a study of this issue. What caused the great rate of increase in productivity from 1995 to 1999 in the United States? And it came up with six industries accounting for 100 percent of the increase. Just six. What are those six? You'll never see me again, may as well answer this, right? Oh, IT clearly. The bottom three were technology-driven industries.

What were the top three? Obviously not technology driven, so what were they? Well, number one was retailing. Total surprise, total surprise to me. Well, Wal-Mart accounted for about 40 percent of it, but something else accounted for 60 percent of it. Number two was the financial industry. And number three was the brokerage industry, not stock brokerage but hauling boxes around, the distribution industry. So, what's interesting to me about those is that they are industries where people would say, "You can't make them productive. They're service industries and they're consumer driven. These are crazy industries." But they were the causes of productivity in the United States.

Busy consumers

And there were two consumer characteristics that led those industries to be reconstituted and in their reconstitution they became more productive. One of those characteristics is that Americans are tremendously busy. People who teach accounting have a great appetite for boredom, so I was leafing through the International Labor Organization yearbook. I recommend it highly. And it noted the number of hours a year people work all over the world. Who are the least hard-working people in the world, in the developed world? The French? Well, my son, U.S. Infantry Captain Alexander Herzlinger, just came back from Iraq so let's not go there. No, it's not the French. And anyway, who knows about those statistics? When I asked my students they said professors. Not the answer I was looking for. It's the Germans. Germans work about 1,730 hours a year.

In Europe, who are the hardest-working, giving allowance for the dubious nature of the data? Who are the hardest-working people in Europe? The British. Marginally, they don't get as much because of the capital-labor ratios in their economy, but they're the-hardest working. They work about 1,860 hours a year.

Okay? We're down to Japan and us. (Now there may be smaller countries like Spain, great economy but still small, that aren't in there.) Who works harder, the Japanese or the Americans? Americans. The average American works 2,000 hours a year. Sixty percent of Americans work more than forty hours a week. I was just in Japan, and in audiences like this there were no women, except those in the back pouring tea. So, we have—I don't mean this as a sociological comment, I'm talking about labor force participation rates—we have more people working, much higher labor-force participation rates, and a very hard-working population.

What does this have to do with retailing? Then I'm going to tell you what it has to do with health care.

Well, retailing was an industry that was run by the kings of merchandising. These were mostly men, except for my Aunt Blanche—that's another story. But these were men who liked to shop and because they liked to shop they thought you liked to shop. In fact, to make it possible for you to really enjoy your shopping experience, they had these department stores. And the way I would go shopping to buy another black thing to go with the eight million black things I have in my closet is I would go to a department store to a department that is named, euphemistically, "career dressing." That means black things for women with hips. And then I would go down to the basement to get some shoes, up to the third floor to get a purse, to the fourth floor to get some black lingerie to go with my black thing. And the idea was that I would love this. Not only would I love this, but that I was so weak-minded and so bored that as I went around the store and somebody sprayed me with perfume, I would just dive in and spend $100 per ounce for the perfume, and so on and so forth.

Well you know, there's nothing like bankruptcy to get in touch with your inner child. So, these stores went bankrupt and the kings of merchandising had a novel idea. And that is to ask the customer what they want. They asked the customer, "What do you want from your shopping experience?" And the answer was, "I don't want a shopping experience. I am busy. And I have plenty of stimulating things to do in my life, thank you very much. Make this very convenient for me."

So, one reason for the great increase in productivity in retailing is we got niche retailing, focused lifestyle retailing. My daughter, who is a physician, goes to Ann Taylor. I go to Talbot's. You have Office Max, Office Depot, Staples, whatever; these are all niche lifestyle-oriented kinds of stores. Now, why are those more productive? Well, you don't need an MBA to figure out that running a niche lifestyle-oriented store is much easier than running an everything-for-everybody store. Not easy, but easier. So, the busyness of consumers forced a change in the retailing industry, and that change made it more productive, contrary to one's intuition.

Well-educated consumers
The second thing about the American workforce is that we are incredibly well educated. The number of people who have graduated from high school has tripled; the number of people who have high school-plus has quadrupled. People who are educated, whether or not they are really smart, think they're smart. And the reason they think they're smart is that's what education does for you. First of all, you can look everything up. And secondly, you're constantly asked to challenge the ideas of world-class thinkers. If you don't know a debit from a credit and you're asked to compare and contrast Milton Friedman and Paul Samuelson, you think, "Boy, I must be pretty smart. These two won the Nobel. I can't be all that bad."

Now, people who think they're smart behave in fundamentally different ways from people who think they're not smart. And I'll give you an example, and the example is in the field of finance, which was the number two cause of the increase in productivity. When I started teaching accounting thirty-three years ago here, I was put into the executive program with people who I thought were ancient. They must have been about thirty-five years old. Nobody took my course. Who can blame them? Accounting is not only boring; it's hard. And it's not, "What do you think Cynthia?" "What do you think John?" "What do you think Herman?" It has a right answer. Or it used to have a right answer. So, people didn't take this course and I'd say to them, "How can you be a business person? You don't know any accounting. You can't do that." And they said something you don't hear anymore. They said, "Well, I don't need to know it because I have a genius accountant." And I'd say, "Well, how do you know he's a genius? You don't know any accounting."

Nowadays, this whole dialogue is unnecessary. People break down the doors to learn accounting. Now, it is not because accounting has gotten more interesting or easier; it's actually much more complicated as the investment bankers dream up ways of getting around the accounting principles. So, it's a very hard field. Now why are they taking it? Because the consumers' psychology has changed. No more genius accountant. I'm the genius. I'm going to learn it; I'm going to do it.

With that change in psychology, the financial markets changed. Thirty-three years ago, most people kept their money in "safe" savings accounts. I put "safe" in quotes because on an inflation-adjusted basis, of course, they were losing a ton of money. And then defined contribution 401(k)s came along and the smart money said, "Consumers, they're as thick as

a brick. They'll never invest in these things. And if they do invest, they're going to get raped and pillaged." And I'm going to talk about that in a bit.

And the mutual funds weren't there. There weren't consumer products that they could use. There was one person along with two others who saw the world differently and people said, "You're an idiot." He not only introduced a consumer-oriented mutual fund, he had it indexed. That man was, of course, John Bogle, and the fund that he started was Vanguard. And others who followed along that same path were Fidelity and T. Rowe Price. They revolutionized the financial markets, driven by consumers' needs for empowerment, and made it more efficient in the classic economic sense and drove down transaction costs in the process.

The impact of consumers in health care
So, when consumers get what they want, driven by these characteristics, they create greater productivity in the industry. And in health care, consumers, busy consumers, are called patients. Hello! "Patients" means my time is very valuable—you be patient. The number one complaint Americans have about the health care system is the amount of waiting they do. The number two complaint they have is about the lack of information. Who would be surprised, given this analysis of their characteristics?

Now, if you doubt that Americans are going to get choice, control, and information in the health care system, let me tell you what's coming down the pike. I mentioned the 80/20 rule; 80/20 also works by age. So, roughly 80 percent of health care costs are spent by people over fifty-five years old. Who just got to be over fifty-five? The baby boomers, the most narcissistic, self-seeking, manipulative, effective cohort we've ever had. And this group is getting sick. Now, why do I label them in this way? Because when the baby boomers were in college and they were chemically impaired, or like our former president, smoking but not inhaling, they got rid of two U.S. presidents. They got rid of Nixon and they got rid of Johnson and they didn't even know they'd done it. "Hey, man, what happened?" So, now we have them sober and sick. The idea that this cohort is not going to push for a consumer-driven system, that's like smoking and inhaling.

Employers
Why do employers want consumer-driven health care? They want it because their costs are out of control. My husband runs a small company. We have about fifty employees. Our health care insurance costs just went up 47 percent: $15,000. In 1989, health care costs and corporate profits were equal. That's the year we went to managed care because people said we've got to do something; we can't continue. So, if health care costs grow by 12 to 15 percent and corporate profits grow by 2 to 6 percent, that's not a sustainable kind of equation. They're going to change. Plus, they're spending more and more and people don't like what they get, so you have got to move off this dime.

Now, what happened with managed care? Why did that not provide the solution? It was supposed to provide the solution. I'm a member of a managed-care plan. I always have been. This is not my personal opinion of managed care; but people don't like managed care. Another thing about managed care is that most of the evidence about the effectiveness of managed care was based on Kaiser, a great organization out in California. Kaiser is not your typical managed-care plan. Kaiser owns about twenty-four hospitals. Kaiser has thousands of physicians who work exclusively for Kaiser. It's a vertically integrated system. You want to replicate Kaiser? You put many billions down on the table. That's what it would cost. So, most managed care was no Kaiser. They went around to doctors and said, "Discount your

fee; I'll give you access to my enrollees." They focused much more on cost than on quality of care.

Now, at the time, the providers of care were very fragmented. So, they'd go to Steve and they'd say, "You'd better discount it because if you don't discount it, I'm going to go to Martha." Well, it doesn't take long for Steve and Martha to figure out that if they join together and become a bargaining unit, the insurers are not going to push them around so much. In Boston, for example, and I'm sure this is true wherever you come from, Mass General Hospital and the Brigham and Women's Hospital that used to be played against each other became partners. So, now they're oligopolists and you can't push them around anymore.

The managed-care model, which was the Henry Kaiser model, was a fundamental change in the delivery of health care. Most managed-care organizations were no Kaisers, and anyway, the Kaiser model is not that popular. I like it, but many don't.

What existed was an imitation of Kaiser that focused much more on controlling costs by getting providers to reduce their prices than by changing quality. It wasn't a Henry Ford innovation and the providers—you know, it's Economics 101. If you have a big buyer pushing you around, you're going to form equal bargaining units so that they can't push you around anymore. Fundamentally, managed care needs much more consumer and provider buy-in.

Providers

The third leg of the iron triangle is the providers. Why do they want it? They want to be able to price. When I published my last book, I went on a lecture tour and I met all kinds of doctors my age—young. Really at, I believe, the peak of their powers, or near the peak of their powers. The reason I say that is because we know so very little about medicine. It's still much more an art than a science, and an artist gets to be fabulous after twenty, thirty years. Before they hit senility, they're right there on the fabulous scale. These were the people who were saying, "I've had it. I'm leaving health care. I just can't stand it. I am not free to practice my art. I cannot deliver health care the way it should be delivered and I'm out of here."

So, they want freedom to price; they want freedom to innovate; they want freedom to bundle care. They want to be paid more for treating somebody with Stage IV congestive heart failure than for treating my twenty-five-year-old son who's a lieutenant [now a captain] in the U.S. infantry and other than his choice of occupation is obviously in much better shape than a person with Stage IV congestive heart failure. They don't have any of this freedom. Not only do they want to leave, I worry about the people who are coming into health care who are so constrained. How attractive an occupation can this be?

Risk-adjusted pricing

You're lucky. I'm out of time, and so I'm not going to go through this chart. This chart illustrates that right now, under the pricing we have now, if they enroll me or my twenty-five-year-old son, they get paid the same. Under risk-adjusted pricing, they're going to get paid much more for enrolling a sick person than a well person. It will make it attractive to have sick people. It will make it rewarding to innovate in the care of sick people. Sick people is where all the money is. Sick people is where all the problems are. This change in pricing will not cost any more in this system, but this revolution in consumer-driven health care will change the care of the sick.

This risk adjustment—you ask how is risk adjustment going to be done? Suppose I am manic depressive, I have a sexually transmitted disease, I have XYZ. Do I really want somebody to know all about that and to adjust my health care costs because I have these? I really don't. So, there are organizations that now exist that do this risk adjustment and they're third-party administrators for risk adjustment to guarantee or protect the confidentiality.

How Consumer-Driven Health Care Solves Problems
Some people say, "Ha, I don't get it. You're waving your hands about consumers, about transparency. The core problem is that costs are too high and the quality is too erratic. How is consumer-driven health care going to change this core problem?" There are three reasons.

Provides choice
There is a branch of research in the field of psychology, and some of those studies are absolutely baffling. Many of them focus on the subject of pain. One of them was a study of when you feel more pain. Do you feel more pain when the nurse comes around and jabs you in the arm? Or do you feel more pain when you say to her or him, "I want it in my right, or I want it in my left"? Clearly you feel less pain when you have a choice and you say, "This is how I'd like the remedy administered." So, consumer-driven health care gives people choice, and that's what people want. It makes them happier.

Controls costs
It controls costs in three ways. One is that it may limit employers' liability. If any of you would like to discuss this with me, I'd be glad to do that. Secondly, as I showed in the Swiss example, transparency controls costs. Consumer-driven health care leads to transparency and just transparency in and of itself, with nothing else changing, controls costs.

But I think the most important way is that it will change health care and do what Henry Ford did, make it better and make it cheaper. How is it going to recreate the health care delivery system?

Provides information*:* How many of you have Quicken? It's going to be a Quicken for health care. I have a quasi-Quicken for health care right now. It's a fat file, which contains all the x-rays I've stolen from my provider and all the lab results and all the files. And the reason I steal the x-rays is that the only person who's really interested in that x-ray is me. And the only way I am guaranteed that the x-ray will be there when I show up again is if I have it in my file. So, under a consumer-driven system, just as Quicken was developed for people with their 401(k)s, we're going to have innovations like this. That will help a lot.

Personalized medicine*:* The second thing is we're going to have personalized drugs and devices. Right now, 50 percent of the twenty-seven drugs that are frequently cited for adverse drug events are linked to genetic variations, which means that my genetic code might be very different from Mark's genetic code in some minute but tremendously important way. This genetic variation is called SNPs or alleles. Little changes in my genetic structure lead to differences in why I need a drug and how quickly I metabolize a drug. Personalized medicine is going to create the right drug for me and the right drug for all of you.

Who wants this? I want it. And in a consumer-driven system, I'm going to get it. How expensive are these drugs? Well, right next to us is the marvelous factory of Genzyme. Genzyme has revenues of $1.1 billion. It has revenues of $600 million from one drug. That

drug is called Cerezyme. How many people take Cerezyme? Ten thousand people have the disease, three thousand to fifteen hundred—I never could get the right answer from Genzyme—take the drug, and you can see why they wouldn't want to give me the right answer if you divide 1500 into $600 million to get some idea of how costly these remedies are.

Are they cost effective? They probably are cost effective in two ways. These personalized medicines enable people who would otherwise die to live. Secondly, they enable people who would otherwise be very sick to lead productive lives. We're going to have personalized medicine and I believe that it, like all technology, is going to be cost effective. Why do I say technology is cost effective? Because I am a graduate of the Massachusetts Institute of Technology. You don't go there because it's a party school. Certainly it was not for me. You go there because you believe in technology. I don't know about you, but I think I would still be back in Russia picking potatoes with my great-great-grandfathers were it not for the industrial revolution, which liberated people who would otherwise be working with their bodies and enabled them to work with their minds. I think we're going to have that same kind of revolution in medicine through genomics and it will lead to greater productivity.

Integrated teams for chronic disease
But the major thing that will change under a consumer-driven health care system is that it is going to lead to a change in how chronic diseases are treated. For example, right now if you're a diabetic, diabetes destroys your circulatory system. You become blind. The number one cost of diabetes is heart disease. The number one users of kidney dialysis centers are diabetics. You get neuropathy in your feet; your nerves are dead; you get huge ulcerations, which cannot heal because of the destruction in the circulatory system. It is well known that if diabetics were treated very early on, with an integrated regimen to help them manage the tremendously strenuous daily care that they need, complications would drop. Imagine if you constantly had to watch your stress level, your eating habits, and your athletic pursuits; that's what a diabetic has to do. It's very hard to do. They have no support in this.

Furthermore, they need a team of people. They need an ophthalmologist who specializes in diabetics, a cardiologist, a nephrologist, a dermatologist, and a neurologist. They need support. They need nutritional support. Where do they get this? They don't get it anywhere at all. The American Diabetes Association has on its Web site "Organizing Your Diabetes Team." So, I'm a diabetic—I'm not—but if I were a diabetic, I would have to find a nephrologist, ophthalmologist, and cardiologist. I mean, it's like asking a paraplegic to build his own wheelchair.

What's going to happen in a consumer-driven system? We're going to get organized systems of care for diabetes, for AIDS, for heart disease. Why will we get this? Because if I had AIDS, and I were offered an insurance policy where I could pick my own team, or an insurance policy with an expert organized team for AIDS, for arthritis, for asthma, for women's health care, for underserved populations, African-Americans, American Indians, people with back problems, what would I choose? Of course I would choose the team focused on my needs. I'd choose Ann Taylor; I'd choose Talbot's. I'd choose a lifestyle-oriented team.

When these teams get together, you get much better and much cheaper health care; for example, in diabetes there's a drastic reduction in heart attacks and circulatory complications.

Right now we have turf warfare. When you read about health care, pharmaceuticals say that the hospitals are the bad guy. The hospitals say that the pharmaceuticals are the bad guy. What we need is an integrated team where they figure out the best package of care for all of us and don't keep pointing fingers at each other. But because our payment system pays for drugs, pays for hospitals, and penalizes people like Ralph Snyderman who try to integrate care, we have this terrible, malicious, destructive turf warfare rather than having better health care.

Varieties of Focused Factories
There are many varieties of what I call focused factories. I call them that to be obnoxious, because I am obnoxious. I call them focused because they're focused on what consumers need and I call them factory because they're a systematic, integrated way of giving care rather than the fragmented system that we now have. And many of them that now exist focus on diseases, focus on procedures. They're the beginning of this revolution.

Denton Cooley
Here's one example: Denton Cooley. Denton Cooley doesn't look anything like this, but he is a Texan. Denton Cooley is a very distinguished heart surgeon in his late 70s. He does only open-heart surgeries. He's good at it. Now, one of the reasons he's good at it is that he's done about 90,000 of them. So, when he cracks open your chest, he knows what side the heart is on. And the team that works with him is a team that focuses on open-heart surgeries.

Do you pay more for it? No, you actually pay much less for it, because with focus you get better quality, and with better quality you get lower costs. In fact, he prices much less than an everything-for-everybody kind of hospital. And I've called him and said, "Why don't you raise your prices? You're the class act in here. You know, you could set the umbrella for everybody else." But he's messianic. He wants to prove the point that when you focus, you get better quality and lower costs. When he made this point to me, I said, "Can I audit your books?" Because I am convinced that at his price, which is about 20 percent lower than the average, he makes a ton of money. I'm convinced he could cut his price to 40 percent lower and still make a ton of money. Now, he may be messianic, but he's not stupid. So, all I can tell you is he prices much lower and I believe that he still makes a lot of money.

Shouldice
Shouldice is a very famous hernia hospital in Toronto. It is so famous that 1,500 people come to Shouldice as alumni every year to celebrate removal of their hernias. It's better and cheaper.

People love going there because they're focused only on hernias and they try to make it a fun experience. You know, when you're focused on only one thing, you're going to make it the best possible. What's their cost? They're $1,000 and it's a privately owned, for-profit firm. Without going into details, I'd say the Shouldices do very well. The average hospital in Ontario: $2,400. So, when you focus on consumers' needs, you make it better and you make it cheaper. Consumer-driven health care is going to lead to that happening.

When and Where
When is it going to come? It's going to come very soon because of all these pressures that I described: 2004.

Where is it going to happen? It's going to happen under the employers' umbrella. It's not going to happen in the individual health insurance market.

The 401(k) revolution
It's going to be like the 401(k). Innovative, consumer-oriented mutual funds were introduced under the employers' umbrella and then they went out as they matured into the consumer market. It is like defined contribution in the control, choice, and information that people have. Somewhere out there is the Michael Bloomberg of health care. Somewhere out there is the Morningstar clone that gives people information in very effective ways, good information in very effective ways.

I went to some newspaper, the *Boston Globe*, to brief them on consumer-driven health care—the editorial board. The Business School sent a communications director along with me to make sure I wasn't terribly outrageous. And they were kind of going along with me until I got to the 401(k) and they said, "Oh, it's terrible. How can you talk about the 401(k) as being a good innovation?" Well, you're all too young to remember this, but I remember waiting for the Dow to break 2,000. How long did that take? Years, yes. Took a decade, at least a decade, to go from 1,000 to 2,000. Then the Dow went from 2,000 to 11,000. How long did that take? It took about ten years. That was the period that consumers participated in the 401(k). My point is, they went from 2,000 to 11,300. They then took a hit and went down to ten. Boy, they had a big upside. Many consumers have done very well—all classes of consumers, all kinds of firms. It's not an elitist or upper-class investment vehicle.

How Individual Consumers Can Change the Market
How does this work? People say, "I don't get it. How are consumers going to make health care cheaper and better?" Most people are stupid. Not us, but most people are stupid. So, how are they going to do this? Well, there are three industries where the average consumer is an idiot. Not an idiot about everything, but an idiot about what they're buying; yet it's gotten better and cheaper. What are those three industries?

Computers, yes. Nobody knows how computers work—well, somebody knows but not most of us. When I graduated from MIT, I had to program a PDP11. Nobody here remembers what that is. It was a DEC mini-computer. I had to program it in FORTRAN, and it cost 150,000 bucks. My cell phone has more computing capacity. But I have no idea how a computer works. It got better and cheaper and I'm an idiot. Along with most buyers of computers.

What's the second product? Consumer electronics, all of those. Better, cheaper, average consumer appliances. What's another class of product that's gotten better and cheaper and the average buyer is an idiot? Automobiles. Cars cost about twenty weeks of income to buy now. They used to cost a year of income to buy. They're safer. I think they're more fashionable. They're certainly more reliable. Remember running to the garage constantly? And nobody knows how they work. They're a bunch of microcircuits. When I go to a showroom and I see somebody looking under the hood of the car, I think, "What the heck are you looking at? You have no idea how it works."

The third one is financial products, where as an old accounting teacher, I'll tell you that most buyers don't know a debit from a credit, a balance sheet from an income statement.

So, how does it work? Who invited her? This is the demand curve, right? The big insight is that when price is high, volume is low. When price is low, volume is high. What is the insight here? The insight is how did the price get to be low? And the answer is that in a market, if 16 percent of the people in that market are smart about that product, they drive it to be better and cheaper and the rest of us just ride along with them. In other words, like

your old economics teacher said, it's the marginal consumer who makes the market, not the average consumer.

Is 16 percent of the population interested in health care? I am happy to announce that health care just crossed pornography as the number one visited site on the Internet. That's 40 percent of the population who are very interested in health care information. And who's interested? It's everybody. You're right—it's everybody. Disproportionately, people like you. Smart, empowered, assertive. Those are the kinds of people who drive products to be better and cheaper, so that's how consumer-driven health care works.

Another key is that you can't be smart without information. I'm smart in buying a car because I have *Consumer Reports*. I have no idea how the damn thing works, but I look for safety and reliability, price. I have very good data, even though I'm a dumbbell, and it makes me an intelligent buyer of cars. We'll have that in health care.

Scare Stories

There are a lot of scare stories about consumer-driven health care: *People are going to have to buy it on their own*. Absolutely not. It's like the 401(k). *They're going to be shot in the head with an Uzi, go to the emergency room, and negotiate the price there.* Absolutely not; they will buy insurance policies*. It's going to screw the sick.* It absolutely will not; it's going to help the sick. If you believe this long story I told you about the focused factories, that's all about the sick. It's going to make things better for them*. It's going to lead to the disappearance of health insurance.* I beg to differ. These policies are very cheap; it will actually help us solve this terrible, shameful problem that we have. We have this great big rich country, and 40 million people are uninsured; many of them are uninsured because health insurance costs too much. These policies are cheap. So, it will actually help solve the problem.

Consumer-driven health care will lead to multiple classes of health care. As if we don't have them right now. Here's what happens in consumer-driven markets. This is an unreadable slide given to me by Dave Power, who is J. D. Power, a fellow accountant. J. D. Power is the guy who ranks cars. What is the message? The message is that in a consumer-driven market, quality always goes up. Second message: The differentials in quality between the best and the worst steadily narrow. Probably right now, the Toyota, for example, in many ways is a better car than the Mercedes. So yes, there are differentials in quality in consumer-driven markets, but quality goes up and the differences narrow.

Lots of stories, lack of access . . .

Your Role: Make it Happen

What is your role? Please make it happen. Empower your employees, the employers among you. If you're a provider in insurance, innovate and don't block measurement. I'll tell you, if you block measurement, you know who's going to do the measurement? It's going to be the U.S. federal government that does the measurement. Much better to do it yourself. The role of government is to oversee and not to micro-manage the delivery of health care. And for all of us, it is to help the uninsured.

In 1999, I had my first conference here. I had it on consumer-driven health care. I did it to help kick off this movement and I'm very happy that now products are called consumer-driven products, so the Harvard Business School helped to make it happen.

Raise a glass of sparkling water—to your good health!`

