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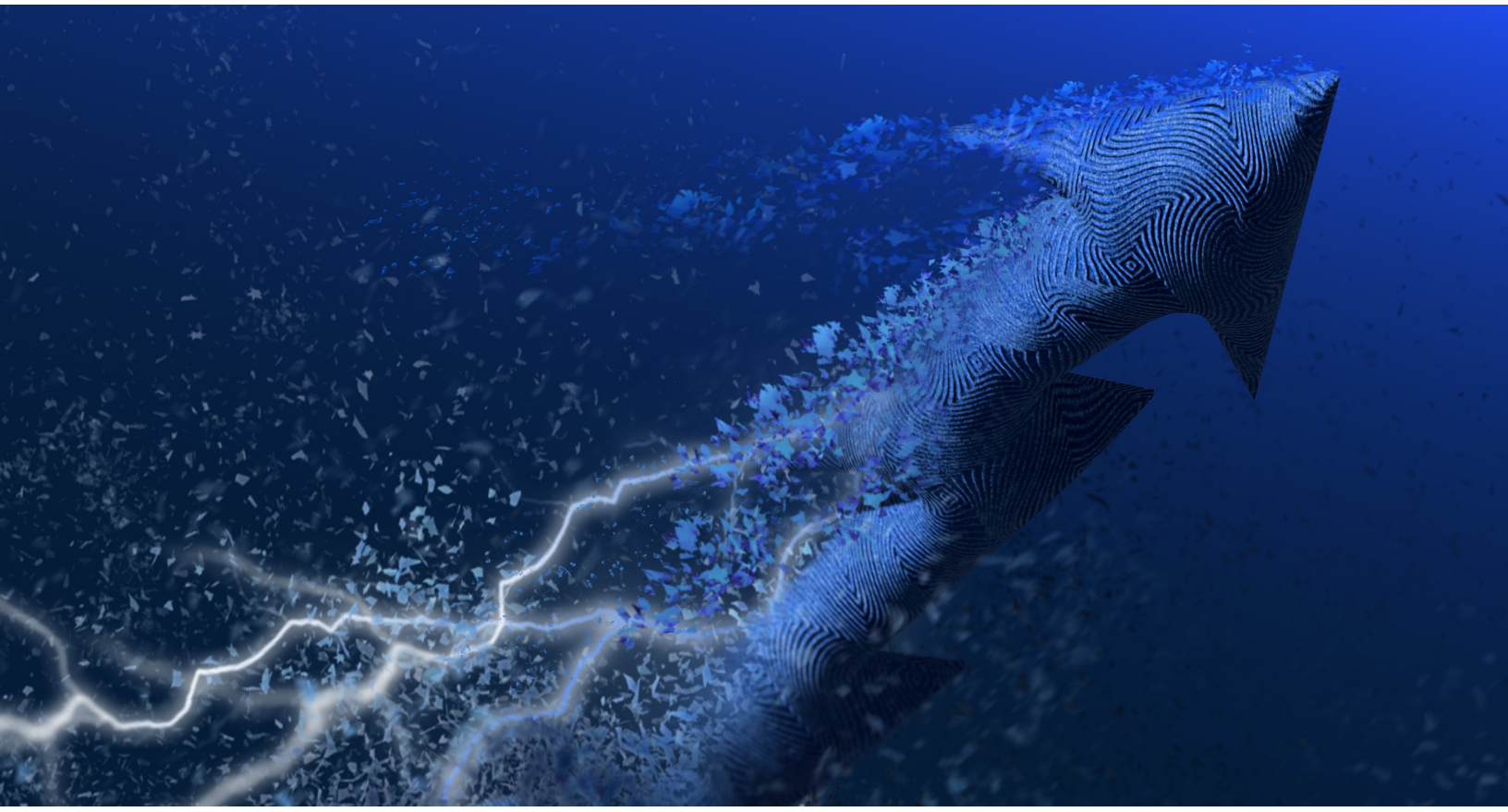
Healthcare Practice

The gathering storm: The transformative impact of inflation on the healthcare sector

Inflation is at record highs and is now blowing through healthcare.

by Addie Fleron, Aneesh Krishna, and Shubham Singhal



September 2022

The once-in-a-century pandemic thrust the healthcare industry into the teeth of the storm. The combination of accelerating affordability challenges, access issues exacerbated by clinical-staff shortages and COVID-19, and limited population-wide progress on outcomes is ominous. This gathering storm has the potential to reorder the healthcare industry and put nearly half of the profit pools at risk. Those who thrive will tap into the $1 trillion of improvement available by redesigning their organizations for speed-accelerating productivity improvements, reshaping their portfolio, innovating new business models to refashion care, and reallocating constrained resources. The healthcare industry has lagged behind other industries in applying these practices; players who are able to do so in this crisis could set themselves up for success in the coming years. This article is the second in our five-article series addressing the gathering storm.

Consumer prices have rarely risen faster than healthcare inflation, but that's the situation today. The impact of inflation on the broader economy has driven up input costs in healthcare significantly. Moreover, the likelihood of continued labor shortages in healthcare—even as demand for services continues to rise—means that higher inflation could persist. Our latest analysis estimates that the annual US national health expenditure is likely to be $370 billion higher by 2027 due to the impact of inflation compared with prepandemic projections.[1]

Pressure on healthcare input costs

Healthcare supply input costs spiked in late 2020 and 2021 during the COVID-19 crisis. Labor costs per adjusted hospital discharge grew 25 percent between 2019 and 2022, closely followed by pharmaceuticals at 21 percent, supplies at 18 percent, and services at 16 percent.[2] While these costs have moderated in 2022, they continue to be above the norm; in particular, growth in labor cost remains high.

Clinical labor

The worsening clinical labor shortage is a significant contributor to our projected increase in healthcare costs over the next five years. By 2025, we expect a gap of 200,000 to 450,000 registered nurses and 50,000 to 80,000 doctors (10 to 20 percent and 6 to 10 percent of the workforce, respectively).[3] These shortages underpin our estimate that healthcare labor cost growth will outpace inflation. We expect clinical labor cost growth of 6 to 10 percent over the next two years, about three to seven percentage points above the prevailing rate of inflation, before a correction to about 0.7 percentage points over the prevailing inflation rate through 2027.[4]

A combination of increasing demand and decreasing supply will drive this shortage. Increased utilization and nursing needs in ambulatory, hospital-based outpatient departments, home care, skilled nursing facilities, and hospice settings could lead to a 7 to 10 percent annual increase in demand for registered nurses between 2021 and 2025. At the same time, higher than normal attrition—7 percent per year in 2021 and 2022 before the rate returns to an estimated 1 to 4 percent in 2023—and retirements will exceed the number of new licensures, decreasing the total number of registered nurses working in direct patient care just as the number of required roles grows. We expect the attrition rate to normalize after 2022 if economic conditions worsen (nurses often keep their jobs or return to work to provide a second household income in tough times). But this factor will not reverse the overall trend. From a cost perspective, any base-pay increases will likely become the baseline; from a practices perspective, many nurses, especially in hospital settings, have sought to move away from direct patient care.

[1] Estimate is based on potential increases in spending associated with excess inflation above historical trend. Nonlabor inflation rate based on forecasted changes in private-services consumption deflator; nonclinical labor inflation rate is based on wage index forecasts that model the historical relationship between wage growth and Consumer Price Index growth; clinical labor inflation rate is based on expert experience. Modeled economic indicators based on McKinsey analysis in partnership with Oxford Economics.

[2] Erik Swanson, *National hospital flash reports: January 2019–June 2022*, Kaufman, Hall & Associates, 2019–22.

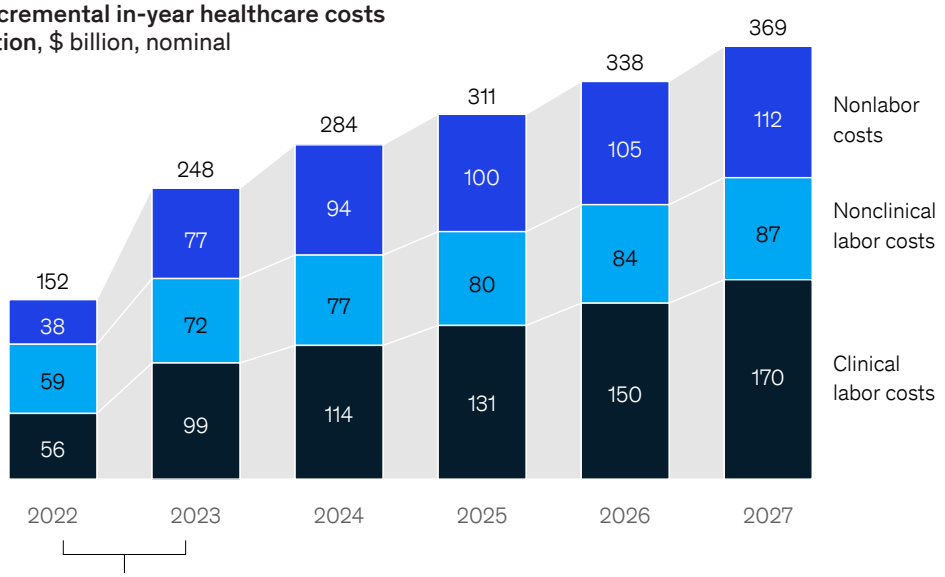
[3] *The complexities of physician supply and demand: Projections from 2019 to 2034*, AAMC, June 2021; Gretchen Berlin, Meredith Lapointe, Mhoire Murphy, and Joanna Wexler, "Assessing the lingering impact of COVID-19 on the nursing workforce," McKinsey, May 11, 2022.

[4] The prevailing labor inflation rate pre-COVID-19 was expected to be 2.8 percent each year 2022–27, and in this revised scenario is estimated at 10 percent in 2022; 6 percent in 2023; and 3.5 percent after that, based on expert input. Modeled economic indicators for pre-COVID-19 estimates are based on McKinsey analysis in partnership with Oxford Economics.

Exhibit 1

The largest portion of potential extra healthcare costs are introduced to the system in 2022–23.

Potential incremental in-year healthcare costs due to inflation, $ billion, nominal



*Inflation and clinical labor wage growth are significantly above baseline trends in **2022 and 2023** before returning to a lower rate of growth on this elevated baseline*

Source: McKinsey analysis in partnership with Oxford Economics; expert input

Our surveys indicate that reasons include a perceived lack of support, safety, and flexibility.[5]

The clinical labor shortage could create $170 billion in incremental costs in 2027, primarily from wage growth as resources become scarce (Exhibit 1). In addition, labor shortages could stymie growth of individual health systems and lead to access risks from site-of-care closures and increased wait times. And we know that when access to care contracts, disadvantaged communities are often disproportionately impacted, a blow to health equity efforts.[6]

Nonclinical labor

As clinical labor shortages worsen, nonclinical labor (for example, personal care aides), especially in provider settings, may be hard hit. For example, additional tasks may fall to this workforce in settings where there are not enough registered nurses. This, in turn, could lead to retention difficulties in this segment.

From a cost perspective, we expect increased inflation in the overall economy to mostly account for incremental wage growth in the nonclinical workforce. Based on analysis of the historical relationship between wage growth and inflation, as well as projections for US inflation over the next several years, we believe that nonclinical wage growth could be up to 3.1 percentage points higher than baseline expectations in 2022, 0.5 percentage points higher in 2023, and 0.1 percentage points higher in 2024.[7] While we expect that the trend itself will return to baseline expectations by around 2025, increases from preceding years would already be baked into labor costs. Altogether, this could result in an incremental $90 billion of cost in 2027 in the healthcare system.

[5] Gretchen Berlin, RN; Meredith Lapointe; and Mhoire Murphy, "Surveyed nurses consider leaving direct patient care at elevated rates," McKinsey, February 17, 2022.
[6] For example, see Elizabeth J. Brown et al., "Racial disparities in geographic access to primary care in Philadelphia," *Health Affairs*, 2016, Volume 35, Number 8.
[7] Baseline expectation was 2.8 percent per year.

Nonlabor costs

The acceleration in nonlabor costs, including supplies, hit the healthcare system hard in the early stages of the COVID-19 pandemic, especially in personal protective equipment. Global bottlenecks have also created supply chain difficulties and increased costs across the economy. We expect that continued supply chain issues will push nonlabor costs above the trend we would have projected in 2019. Using consumption deflators as a proxy for how costs could rise across the system, we expect additional nonlabor costs to increase by up to $110 billion in 2027. These costs would likely become permanent.

When and how might employers, government payers, and consumers experience healthcare inflation?

At present, the increase in healthcare input costs is being felt primarily by providers. This is largely driven by a lag in contracting and renewal cycles.[8] It can take several years for the impact of inflation to filter down to reimbursement rates, particularly for payers in government lines of business.

In commercial (employer-sponsored) lines of business, providers' ability to pass on increased costs is governed by contracting life cycles (the average contract locks in specific rates and inflation escalators for about three years) and by the outcome of negotiations. Given this contracting life cycle, we expect that it will take one to three years for incremental costs associated with the commercial population to flow from providers to payers. Payers' ability to pass these costs onto employers will be linked to bid cycles, with the first major impact likely occurring in the 2024 pricing cycle (to be negotiated in 2023). Employers, in turn, will then face the choice of bearing these increased costs or, as is more likely, passing more costs onto employees.

A survey of more than 300 employers revealed an average growth in cost of health benefits of 6 to 7 percent in the past three years; it also revealed that rate increases greater than 4 to 5 percent are unsustainable. Further, 95 percent of the employers surveyed reported that they would consider reducing benefits if costs increased 4 percent or more.[9] The top two cost-control actions that employers said they might pursue were increasing the employee share of premium costs and a shift to high-deductible health plans.

Government payers (Medicare and Medicaid fee-for-service) would likely start to see increased costs in two to three years, given standardized methodologies for using historical inflation rates to set next year's prices. For government payers to raise rates sooner, the Centers for Medicare & Medicaid Services (CMS) or state Medicaid agencies would need to be willing to use current experience to override historical rate-setting methodologies.

CMS recently finalized inpatient prospective payment system (IPPS) increases of 4.3 percent in fiscal year 2023 compared with the originally proposed 3.2 percent.[10] This adjustment could indicate that the flow-through costs to government payers could happen slightly earlier than historical experience would indicate, but we still do not expect that it would entirely alleviate the cost pressures discussed in this article. For example, we estimate that clinical labor wages will increase 10 percent this year, nearly six percentage points higher than the IPPS rate increase. Private payers in government lines of business (Medicaid managed care and Medicare Advantage) would likely not see additional government revenue until 2026–27, given how prices in those lines of business are set.

Also, premiums may be on the rise on insurance exchanges. A recent analysis[11] of 72 marketplace insurers' early rate filings in 13 states and the District of Columbia found that these insurers were seeking higher premium increases (median increase is 10 percent) than in recent

[8] Aneesh Krishna and Shubham Singhal, "Consumer prices are rising fast, and healthcare isn't far behind," McKinsey, February 11, 2022.
[9] McKinsey Executive Survey, July 1, 2022.
[10] "FY 2023 hospital inpatient prospective payment system (IPPS) and long-term care hospital prospective payment system (LTCH PPS) final rule—CMS-1771-F," Centers for Medicare & Medicaid Services, August 1, 2022.
[11] "Consumer prices are rising fast, and healthcare isn't far behind," February 11, 2022.

years, largely due to rising prices paid to hospitals, doctors, and pharmaceutical companies and increased use of services by enrollees. Compared with recent years, relatively few insurers are seeking to lower premiums; only four out of 72 insurers filed negative premium changes, while the remaining 68 insurers requested premium increases. Some plans are seeking increases of more than 25 percent.

We modeled three extremes of impact to better understand what might happen to industry profit pools (Exhibit 2). First, what happens if spending increases, but there is no new revenue from any source? Second, what happens if spending increases, and the increases are passed on to payers in the form of unit price increases, but payers are unable to pass these increases to end customers such as employers or state governments? And lastly, what happens if payers are able to pass the increases to end consumers of healthcare?

Our analysis shows that if players do not take any mitigating action, industry profit pools will erode in all three scenarios, due to the lag in contracting cycles described above and the inability of most players to pass on increased administrative costs. The magnitude of the impact varies, and even within each example the impact on any one company could differ greatly compared with other firms.

Healthcare leaders expect inflation to hurt growth

We surveyed several healthcare leaders, many of whom say they are resigned to a sharp decline in operating margins.[12] Payer and provider executives reported that they expect a drop in margins of between 25 and 75 percent, or one to three percentage points. Many payer and provider organizations have operating margins in the range of 2 to 4 percent, implying that earnings could be wiped out.[13] This situation

Exhibit 2

How impacts of inflation are felt in the healthcare industry will depend on the amount of new revenue available.

EBITDA erosion in 2027 by scenario, $ billion

- <10% erosion
- 10–50% erosion
- >50% erosion

EBITDA impact if no new revenue enters the system
Providers are unable to pass on costs to payers and bear most of the impact

EBITDA impact if unit prices increase
Provider reimbursement rates increase in line with standard market timelines for rate increases, at the inflated rates; premiums do not increase

EBITDA impact if unit prices and premiums increase
Provider reimbursement rates increase in line with standard market timelines for rate increases, at the inflated rates; premiums increase commensurately

All scenarios assume that outside of rate contracting, no mitigating action is taken by actors within the system to capture the $1 trillion+ of improvement opportunity

NHE impact	Minimal	Moderate	High
Provider	●	●	●
Payer	●	●	●
Pharmacy services	●	●	●
Manufacturing	●	●	●
Services and technology	●	●	●

Impacts in 2027; short-term erosion especially in 2022–23 may be higher due to lag in when costs are passed through

[12] McKinsey Executive Survey, July 1, 2022.
[13] "FY 2023 hospital inpatient prospective payment system (IPPS)," August 1, 2022.

could necessitate drastic responses. Executives at tech-enabled organizations, however, have more positive views, as they are expecting that payers and providers will rely more heavily on technology to promote efficiencies. These executives said they expected a drop of about 15 to 50 percent, or one to five percentage points, in operating margins.

Some of the actions these executives take could include layoffs. For example, more than a quarter of executives surveyed believe that they may have to let go of at least 10 percent of their workforce in the next six to 18 months. At the same time, attracting clinical talent was the number-one priority for providers, indicating that layoffs would likely affect nonclinical employees. Further, to address the gaps in clinical labor, providers are considering several actions, the top two being use of technology to reduce labor burden (66 percent of surveyed executives) and skill-mix optimization to enable clinicians to practice at top of license (64 percent).

Rate increases are unlikely to offer a way out. While they may seem like the easiest path, payers recognize that price increases beyond historical levels are unsustainable; therefore, other actions will be needed. The actual financers of healthcare—employers, government, and consumers—can't afford more than historical levels of increase, if that.

Also, capital has become more expensive. Over the past 12 months, healthcare market valuations have trended lower as well; the S&P 500 has dropped by about 15 percent, while S&P Healthcare fell by 10 percent.[14] And capital availability has tightened. Over the past 12 months, the federal funds rate has increased by 225 basis points, to 2.50 percent.

The moment is now to address productivity

A $370 billion risk to industry profit pools by 2027 seems insurmountable—without mitigating actions, it could both make healthcare even less affordable and threaten sustainable industry margins (for example, $370 billion is nearly half of the projected industry EBITDA in 2027[15]). But we already know that more than a trillion dollars of value is available in the healthcare system that has not yet been accessed. This is the perfect storm that could spur the industry to address productivity gains. For example, the combination of cost pressures and a labor shortage provides an incentive to use technology-enabled levers to increase productivity, as any move to do so would free up capacity to meet demand and improve access while also reducing costs.

Healthcare executives will need a disciplined approach and fast action if they want to come out stronger from this period. Well-known tactical actions exist that can spur the required improvements, just as a set of well-understood organizational measures can help companies thrive during a period of uncertainty. The real question for the healthcare industry is whether incumbent stakeholders will be able to quickly set high aspirations in these areas, align the organization around them, and execute with the requisite speed. Those that do not only will weather the storm but may well come out ahead.

[14] As of August 26, 2022.
[15] Neha Patel and Shubham Singhal, "The future of US healthcare: What's next for the industry post-COVID-19?" McKinsey, July 19, 2022.

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The authors wish to thank Daniel Brown, Sonja Pedersen-Green, and Cara Repasky for their contributions to this article.

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