

IS THE HEALTH CARE SECTOR INFECTED BY BAUMOL'S COST DISEASE? TEST OF A NEW MODEL USING AN OECD DATASET

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Rising health care costs are a policy concern across the OECD. Since 2000, health care expenditures as a share of GDP have climbed from 7.8% to 9.6% in 2009. Relatively little consensus exists concerning the drivers of this increase. One hypothesis that has received attention in the literature is “Baumol’s Cost Disease”. According to this hypothesis, the health care sector is characterized by (i) relatively little substitutability of capital for labour, and (ii) relatively little productivity growth. Because wages must rise in the health care sector to keep pace with other sectors, increases in health care costs are hypothesized to be due to higher wages and the lack of substitutability of capital for labour. Developing a theoretically-appropriate test of Baumol’s Cost Disease for the health care sector has proved a challenge. My paper will develop a two-sector model of the economy (Health Care and Non-Health Care sectors) that investigates Baumol Cost Disease. It derives two hypotheses that allow testing as a function of observable variables: 1) The price index of the health care sector relative to the price index of the non-health care sector, and 2) the share of total labour employed in the health care sector, are both positively related to economy-wide productivity. My data consists of annual observations on 16 OECD countries over the years 1995-2013. Preliminary results find strong support for the hypothesis that Baumol’s Cost Disease is an important driver of increased costs in the health care sector.