**IlLUminate Blog Transcript: Andrew Olenski on Nursing Homes’ Hidden Profits**

Recorded May 13, 2024. Listen to it here.

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| ANNOUNCER: 00:02 | [music] This podcast is brought to you by ilLUminate, the Lehigh Business blog. To learn more, please visit us at business.lehigh.edu/news. [music] |
| JACK CROFT: 00:14 | Welcome. I'm Jack Croft, host of the ilLUminate Podcast for Lehigh University's College of Business. Today is May 13th, 2024, and we're talking with [Andrew Olenski](https://business.lehigh.edu/directory/andrew-olenski) about a [recent study](https://www.nber.org/papers/w32258) he co-authored with [Ashvin Gandhi](https://healthpolicy.ucla.edu/about/staff/ashvin-gandhi) of UCLA that was published by the National Bureau of Economic Research. The study found that almost two in three nursing homes in Illinois tunnel profits to related companies to inflate costs and decrease profits reported to government regulators. Doctor Olenski is an assistant professor of economics whose current research focuses on the nursing home industry, using novel methods to measure provider quality, and examining the health consequences and policy implications of the ongoing contraction of the nursing home industry. Thanks for joining us on ilLUminate today, Andrew. |
| ANDREW OLENSKI: 01:09 | Thanks so much for having me. It's great to be here. |
| CROFT: 01:11 | Now, your study looks at tunneling practices in health care, and I confess that's not a term I had come across previously. So let's start by talking about what does tunneling mean in economics, and how prevalent is the practice across different sectors in the economy? |
| OLENSKI: 01:31 | Of course, of course. So I'll confess that I also had actually not come across the term tunneling before working on this paper. The term tunneling actually comes from the corporate finance literature, which is not really an area that I tend to work on. I usually work in the health care-- work on health care issues. And the term tunneling was actually initially coined to describe the expropriation of minority shareholders of companies in the Czech Republic following the fall of communism, right? The idea being that in the '90s, as we're going through this big period of privatization in the Czech Republic, what was a common concern was that the controlling shareholder of a particular company might try to, well, essentially, screw over the minority shareholders by trying to transfer assets or profits out of the company that they control to a company where they have full cash flow rights. Hence, the idea being that if I pay out-- suppose I wanted to pay out profits today, right? I could pay out profits in my current company where I have maybe a 50% ownership share, or I could pay out profits to a related company where I have 100% ownership share. And so this idea of moving assets from one company to another as if through a tunnel is where the idea comes from. |
| CROFT: 02:53 | And what is it about health care, in particular, that makes tunneling advantageous? |
| OLENSKI: 03:01 | I kind of gave the original background of tunneling, right, where the term comes from and why firms would maybe want to do this. But what's interesting about the health care industry is that there are actually lots of reasons why one firm might want to tunnel profits or assets to another, right? So at the simplest level, the problem might just be that if you have two entities, one's a health care provider, and one is some third-party company owned by the same owner as the provider. If the owner wants to avoid some sort of regulation, or if they want to try to hide profits from the regulator in some way, then shifting profits from the health care provider to a related party will effectively do that, right? So for instance, it might be that I'm a health care provider, and I'm trying to negotiate for higher reimbursement rates from the government, right? One really effective way of doing that might be to say, "Look. Look how unprofitable I am," right, "Look how low my profit margins are. You need to increase my reimbursement rates, or else I'll close." |
| OLENSKI: 04:14 | One way of making that argument really strong is by showing how unprofitable you are, right? And so the idea here is that what you might see is providers essentially moving money from their left pocket to their right and then showing their left pocket to the regulator and saying, "Hey, look. My pocket's empty." Another reason why you might expect to see this sort of tunneling practice of shifting profits from one entity to another that's particularly advantageous in health care, there's a lot of discretion when it comes to enforcement actions, and in particular, what you might be concerned about if you're a regulator, and you have some health care provider that maybe their quality isn't up to snuff, and maybe they have had a number of violations in the past. You might be concerned about closing this provider down or giving them a big fine if you think that this provider's exit would be costly to patients in terms of access, right? So the story I think you should have in mind is imagine you have a nursing home, and this nursing home is the only nursing home in the county, right? So we're in a rural area, and there's only one provider left. The regulator might be really reluctant to very aggressively fine this nursing home if they think that a large fine might result in, say, the facility closing down, because at that point, you're going from one bad nursing home to zero nursing homes. And so trying to convince the regulator that you are a financially vulnerable nursing home can help you to avoid some enforcement actions. |
| OLENSKI: 05:58 | And then finally, the other thing that comes to mind here is there's this really kind of long history in health care of malpractice risk being an incentive for improving quality, right? So if I'm a nursing home, one reason why I might want to provide high-quality care is the concern that if I don't provide high-quality care, and I have patients who are frequently being injured or harmed as a result of my care, they might sue me for malpractice. This malpractice risk really gives me a strong incentive to try to improve my quality of care. One reason why you might want to move profits from a health care provider entity to some other entity is to try to reduce that malpractice risk, because in general, you can't recover damages from an entity that has no money to pay out. So by appearing to be very unprofitable, by shifting all your assets off book, you might potentially deter malpractice litigants by appearing on paper as if you have no funds. |
| CROFT: 07:02 | Without getting too far into the weeds, what information did you examine to conduct the study? How did you kind of trace where the money was going and what was happening? |
| OLENSKI: 07:12 | So the idea in this paper is that, basically, every health care provider, and in particular, every nursing home - and this paper is about the nursing home industry, of course - every nursing home is required to submit annual financial data to the government. They will submit financial data on their revenues and costs of providing care, both to the federal government, as well as to each state. The states where they operate, of course. And the point of these data, these cost report data, as they're known, is to try to give the government some idea of how much it costs to produce the care that they're paying for, right? Most health care is purchased by the government. So the government is really concerned with how costly it is to produce this care. What we do is we say, "OK. Let's look at these cost report data, where we see how much money nursing homes are spending on different categories." And we say, "Okay. Well, how much of this money is being paid out to related parties?" Where, again, a related party is just any company that shares common ownership with the nursing home. So think about a real estate company that owns the building that the nursing home operates in. What you might have is a situation in which the owner of the nursing home also owns the real estate company that owns the building. So on the nursing home's books, they're not the owner of the facility. They just pay rent to this other company. And what we do is we look and see, essentially, how much money are nursing homes paying out to these related parties? We try to use this measure of cost to assess how much nursing homes are shifting profits. |
| CROFT: 08:56 | As I understand it from your study, this practice is, not that it was invented recently, but that there has been a spike in how much of this has been going on over the last 20 years. Is that the case? |
| OLENSKI: 09:14 | This practice of paying related parties for goods and services has definitely been increasing over the last 20 years or so. So we kind of trace the start of this growth back to this law review article from 2003, where these two lawyers made this argument that one way that nursing home chains can try to reduce their malpractice risk is by slicing the nursing home entity up into smaller companies, right, one company for management services, one company for real estate, one company for therapy, one company for pharmaceuticals, and so on. The idea is that, as I said earlier, slicing the company up into these smaller chunks might help to deter malpractice risk as well as to reduce spending on malpractice insurance. This paper comes out in '03 that makes this argument that this would be beneficial to nursing homes. And around that time, we start to see this real explosion of related party adoptions. Prior to this study or this article in the early aughts, there was maybe around 40 to 50 % of facilities engaging with some sort of related party transactions. And now, I would say it's about 80% of nursing homes engage with some related parties in one way or another. So we have seen pretty steady growth in this area that, increasingly, providers seem to be transacting with related parties in one way or another. |
| CROFT: 10:41 | Was there a specific reason—and you studied the information from the state of Illinois. And was there a specific reason you focused on Illinois for this study? |
| OLENSKI: 10:55 | I mentioned that we were using these cost report data that do exist federally, but also exist from each of the 50 states. And the reason we look at Illinois, specifically, is that Illinois has been very acutely aware of this problem for decades, the problem of nursing homes trying to shift money out of their pockets into the pockets of related parties. The regulators in Illinois have really been keeping their eye on this issue. And as a result, they've been collecting data on the total amounts, the total amount and type of related party transactions for the last two decades or so, meaning we can actually trace the growth of this sort of transaction in Illinois, going back to at least 2000, which as far as we know, is the longest time period that anyone's been tracking this data. While our study is unique to Illinois, right, we are just looking at the nursing home industry in Illinois and how nursing homes might try to hide profits through related parties in Illinois. We don't think this is an Illinois-specific problem, right? What I mean by that is we think this is happening everywhere. It's just that Illinois happens to be a state where they're looking for it, right? Because they're looking for it, we're able to measure it. So you might imagine that in states where the government's not looking at this problem, the problem may be even more pervasive. |
| CROFT: 12:19 | Now, you'd mentioned that real estate and management services that have the same ownership as the nursing homes are two of the categories. And they are, as your study found, the two most common areas where the inflated costs are found. So what were your key findings related to those transactions between nursing homes and the facilities that they're running and the management services that they're contracting for? |
| OLENSKI: 12:56 | We found that the vast majority of related party spending was on real estate and management services, right? And what I mean by that is, if you were to take all the dollars spent on related parties, so companies that share common ownership with the nursing home, something like 75% of them go to either real estate or management services. So we look at these two types of contracts, in particular. And what we find is that when a facility starts adopting-- when the facility adopts a real estate company or a management company, their total spending on management or real estate increases somewhere between 20 to 30 percent, right? So that tells us that we think the payments to these companies are being inflated by about 20 to 30 percent. And that's actually really useful. That's a really useful number to know because that number lets us figure out, "Well, how much should we be deflating their reported costs of real estate and management when they're contracting with one of these related companies?" And by deflating the costs by the amount that we think they're being marked up, we can try to figure out how much money is being tunneled to these related parties, right? And by figuring out how much of this money is being tunneled to the related parties, we can figure out what is the overall profitability of the nursing home industry, right? What's the true profitability of the nursing home industry, taking both the observed profits as reported to the government, plus the hidden profits that are flowing through one of these related parties? And what we found was pretty striking. We estimate that about 63% of nursing home profits are hidden in this way. So what I mean by that is for every dollar of profits that flow to the nursing home industry, about63 cents of them are hidden in a related party, meaning if you just looked at reported profits, right, how profitable the industry says it is, you would only be getting about 37% of the total picture, right? Meaning that the hidden profits are more than twice as large as the true profits, which we think is a really striking result and goes against a fairly long-running narrative that the nursing home industry is extremely unprofitable. |
| OLENSKI: 15:07 | The consensus has been for decades that this is a very unprofitable industry that is desperately in need of higher reimbursement rates, or else, every facility will be on the verge of exit. And our results really kind of contradict this narrative. We think this is actually very plausible for a couple of reasons. So the first is that one of the hallmarks of this industry over the last 10 to 15 years has been an explosion of private equity investment. There's a lot of private equity money flowing into the nursing home industry, which we find a little puzzling if the industry is really so unprofitable, right? Why are investors buying up these facilities, at generous valuations, mind you? It's not that PE is moving in and buying these facilities on a huge discount, right. Then it might make sense. But now, we're finding that investors are purchasing these facilities at very generous market prices, which is a very difficult fact to square with the idea that the industry is so deeply unprofitable. Similarly, if you just looked at the reported profits, you would find that somewhere in the ballpark of 50% of facilities in a given year claim to be unprofitable. We think that this is a very surprising number, given that the exit rates, right, the percentage of facilities that close in a given year, are only in the 1-to-2-percent range, right? So the closure rates are actually relatively low for an industry that's 50% unprofitable. So we think that these two facts, that the closures are relatively uncommon, and the private equity valuations are very high, are very difficult to square with the idea that this is a very unprofitable industry. And we think that the way to resolve these two puzzles is by trying to-- is by pointing out the magnitude of the problem with these hidden profits. |
| CROFT: 17:01 | Now, one of the other things your study found is that-- it seems like a puzzle just at first glance, is that in cases where a nursing home does begin paying one of the related real estate firms rent for its facilities, that somehow both companies report negative equity on the deal. Which raises the question, which I know you raise in your study, where does that money go? |
| OLENSKI: 17:29 | So this is, I think, one of the more interesting pieces of our study, which is that not only do we get to observe the costs of the nursing homes, right, and how much money they're spending on related parties, we actually get to observe their balance sheet data as well, so their total assets and their total liabilities, as well as the assets and liabilities of any related parties. So one of the things we get to do is say, "OK. We're interested in," for instance, "the adoption of a real estate company," meaning what you do is you own the building. You sell the building to a related party. Then you start paying rent to that related party. We just talked about how we found that the total rents that you're paying are larger than what you were previously spending on real estate, right? That's the inflation in the real estate payments. So a natural question is like, "Well, if you're paying more rent, are you getting anything for that?" right, "Are you getting anything for the fact that you now have the privilege of paying a higher rent?" And what we find when we look at the balance sheet data is no, right? The nursing homes appear to be made much worse off after one of these transactions, meaning both their assets and their liabilities go down, of course, but their assets go down by more, meaning their equity, the difference between their assets and liabilities, becomes negative, right. The nursing home appears to be basically worthless on paper, if you just look at the balance sheet data. |
| OLENSKI: 18:55 | So that's quite puzzling, I think, and very hard to square with the idea that this is some sort of above-the-board transaction, right, that you're losing value, right? You're losing net value in the nursing home entity for the privilege of paying a higher rent. So from the nursing home's perspective, this is unequivocally a bad deal. And from the related party's perspective, what's interesting is that this also appears to be a bad deal. [laughter] The related parties also seem to be made-- seem to be valueless, essentially. I mean, they have negative equity. They have more liabilities than they have assets. And so the question that this raises is where did the money go, right? There was value, and now, it's essentially disappeared off the books. We think that what this highlights is that when you shift these assets to a related party, it's not like the assets then sit around on the related parties’ balance sheets. Instead, the value is being paid out at some point beyond the related party. We don't know exactly where the money's going, but it seems very hard to imagine that it's going anywhere other than payouts to owners, right? This is just a holding company. So there's not much that these entities could be doing with their new assets other than paying out to owners and shareholders. |
| CROFT: 20:17 | Now, is it possible that the reason, particularly on the nursing home side, for the big increase in costs is that there are renovations to facilities happening at these places or other quality improvements that might account for that money? |
| OLENSKI: 20:39 | This is a really crucial, crucial point when thinking about our study, that one of the things that we have to do is we have to make this assumption that when you adopt a real estate company, or you adopt a management company, that you're not simultaneously experiencing some very large jump in your costs, right, whether that's because you're dramatically expanding your management team, or you're engaging in some massive expansion in the operations or capacity of your building, right? If it turns out that the building is suddenly-- if it turns out that the building is undergoing massive renovations and that this is why you have this big jump in costs, then it would be unfair for us to characterize this as an inflated payment. So we take this idea pretty seriously, and we look at it pretty closely. And what we find is that there's very little evidence that there is something major happening economically at these firms when they adopt a related party. So the first thing you can do is just say, "OK. Well, did the facility expand capacity?" right? You can just look and see how many beds did the facility have, and did the total number of beds go up after an adoption? And there, we find, no. We find essentially no change in the bed size. We also find no change in the scale of the operations. So we don't see any change in the total number of patient days that are served, as well as no change in other costs. What I mean by that, other costs, is that if you think that what's happening is that the facility is scaling up in some way, right, in some way that it is increasing its costs, then you would expect costs to increase across different line items. So for instance, we see these big jumps in real estate spending. But if we think that this reflects some overall increasing costs, we might expect to see increases in pharmacy or in therapy or nursing services. But we find no evidence of any changes in spending on these categories, right? |
| OLENSKI: 22:35 | So the only areas in which we're seeing big jumps in costs are the areas in which facilities are transacting with related parties, right? So there's no change in the other cost centers that you might expect to see if there's some real improvement in the facility output. And at that same level, we see no real changes in any of the patient health outcomes. So I actually think that this is a pretty good thing, right? And what I mean by that is, you might be concerned that what's going on is that I'm cutting all these nurses, and I'm using the extra money to pay out higher-- to pay higher rents to my related parties, but we don't really see anything like that. We see no changes in patient outcomes. We see no changes in staffing levels, nothing like that. We think that this is a purely on-paper transaction, that you had money that you were previously reporting as profits, and now, you're reporting as costs, that there's no real economic change. And then finally, kind of the most compelling evidence, we think that this is not the reflection of some large quality investment in the nursing home, is simply the scale of the jumps. What I mean is that we find that real estate jumps about 20, 25 percent in one year. You would be hard-pressed to find any sort of quality investment that would increase the value of tenancy by 25% in one year, right? The real estate and management are not areas where you normally expect to see cost shocks in the order of 20, 25 percent, year over year, that these areas tend to be relatively stable over time. And so the sheer magnitude of the jumps, we think, is pretty compelling evidence that this is not just the reflection of some sort of quality investment. |
| CROFT: 24:19 | In terms of the concern that the quality of nursing home care for patients could be affected, I think there's a current debate going on in Congress over Medicare's proposal to set nursing staff minimums for nursing homes. And it's opposed by both nursing home industry groups and some members of Congress for the reason you've talked about before, because they contend that adding more staff, forcing them to add more staff, will in turn force facilities working on these low or negative reported profit margins to close, and that there will be less nursing home care as a result of this. So what potential policy implications does your study contribute to that debate? |
| OLENSKI: 25:14 | Of course. Yeah. This is a hugely contested issue right now because of the proposed Medicare role around the federal minimum staffing regulation. And I think that there's a lot that our study can contribute here. Of course, both Washington and at the state level, there's a lot of interest in nursing home reform. There's a widespread concern over the low level of quality in the nursing home industry. And essentially, everyone is in agreement that the cause of the low level of nursing home quality is the inefficiently low staffing levels. Nursing care is basically entirely labor intensive. And so if you want to improve quality, you just need to hire more nurses. Industry has argued very, very forcefully that the reason why nursing homes seem to be insufficiently staffed is because they are too unprofitable to hire more staff, right, that they would love, love, love to hire more nurses, but unfortunately, their profit margins are just too thin, and they really can't spare the extra dollar to hire an additional nurse, all right, which is, of course, what brings us to the [CMS](https://www.cms.gov) [Centers for Medicare and Medicaid Services], the Medicare rule that you just talked about, which would impose a floor of the total number of nurses per resident. The industry groups have lobbied pretty hard against this, saying that, of course, that this is an unfunded mandate that would result in bankruptcy and closure of many facilities who were right at the margin of exit. |
| OLENSKI: 26:46 | And I think when you think about our study in the context of this debate, it's important to be somewhat careful in terms of the implications. So first, what our study suggests is that, on average, there is a lot more money out there than what the industry claims. We say that about 63% of profits are hidden, meaning that most profits are actually flowing through one of these related parties. Right off the bat, our contention is that the industry is not being particularly forthcoming when it comes to how profitable they are and that this is just no way to have a conversation around what sorts of reforms are viable. If one side is, I don't want to say fabricating data, but at the very least, if one side is masking what they can afford, then we're not in a good place to be having a discussion around what is viable. Because the amount of hidden profits we uncover would actually translate to a pretty substantial increase in the total amount of staffing. So just as a thought experiment, one of the things we do is we calculate, "OK. If we were to just take every dollar of hidden profits that we found, and we convert them to nurse hours, how would total nursing increase? How would total nurse hours increase in the industry?" And we find that our hidden profits would correspond to about 30%, about a 30% increase in statewide nurse staffing, right, which would be a massive, massive increase over the status quo. It would bring many, many facilities into compliance with this proposed rule. |
| OLENSKI: 28:20 | Now, I want to be clear that this is just a thought experiment, right? We are not saying, "Hey, tomorrow, if every facility converted their hidden profits into nurse staffing, everything would just be fine." There's reason to worry that if you take profits out of an industry entirely, that you will actually see exits, and you will see closures, right? You may expect some capital flight. You may expect investors to start leaving the industry, and so on. So I view this 30% number not to say, "Hey, here's how much the industry could actually afford," but rather to say, "Here is a way of trying to quantify what we mean when we say that 63% of profits are hidden. This is a large amount of money that we're talking about." And then finally, the one thing I want to kind of caveat this all with, as I said, I do want to be careful with how we're thinking about these issues, is that we do find that a pretty sizable number of facilities have near zero hidden profits, right? About a third of facility years in our data have zero or almost zero hidden profits, right? And for these facilities, right, if they are on the margin of closing, then a large increase in their costs might actually reduce access to care for their patients. And that is something that's worth taking seriously. |
| CROFT: 29:37 | Now that raises another concern that's been debated for years and years now, which is financial integrity and transparency in the nursing home industry. So are there policy implications your study has that could strengthen that and maybe get us onto a firmer ground to have the debate that we should be having, as you were talking about earlier? |
| OLENSKI: 30:10 | Definitely one of the first order takeaways from our study is the importance of trying to improve the-- trying to improve financial integrity and ownership transparency in the nursing home industry. And there, I think there are a number of immediate policy takeaways. So the first is, at a base level, we just need to measure this stuff more. We need to measure this stuff better. So like I said, our study is using data from Illinois, because in Illinois, they've been taking this problem seriously. And the way you take this problem seriously is you ask firms to include related party transactions in their cost reports, right, as Illinois does, and then you audit their data as well, right? That is the crucial piece here. If you don't threaten any penalties from misreporting data, then facilities are not going to report truthfully. This is, I think, the really crucial step that CMS needs to take in terms of increasing transparent-- in terms of increasing financial transparency, is ensuring that facilities are submitting all the data that they're supposed to be submitting, and doing so by threatening to audit, or by auditing some small share of cost reports to ensure that the data that's being submitted is, in fact, the truth. So I think this is kind of the immediate takeaway that we can't improve something if we haven't measured it. And right now, we are not measuring this very effectively at the federal level. |
| CROFT: 31:34 | Now, we've covered a lot of ground here today, but I do want to offer you the opportunity if there's anything that we have not discussed regarding the study and the issue of hidden profits in health care that you think our listeners should know? |
| OLENSKI: 31:54 | Our paper is about the nursing home industry, right. This is an area that I and my co-author know very well, and we've worked here for a long time. But one of the things I want to point out is that this is not a nursing home-specific problem, that this issue of profit tunneling and related party transactions, we think, are potentially widespread across the health care sector. We know that related party transactions are common in other health care industries, such as dialysis, home health care, hospice, etc. We've talked to a number of other researchers who have widely suggested that this sort of practice is actually quite common in the hospital industry as well. For instance, you might want to try to justify your nonprofit status. One thing you might want to do is try to inflate your costs in one way or another. So while this concern around profit tunneling, right, while our empirical evidence is only around the nursing home industry, we think that this is a really ripe area for further policy, policy work, and further investigation across health care more broadly. |
| CROFT: 32:59 | Now, I'd like to again thank our guest, Andrew Olenski. Andrew's research on health care delivery and physician decision-making has been featured in the New England Journal of Medicine and the American Economic Journal: Economic Policy, among other leading peer-reviewed journals in health policy, medicine, and economics. This podcast is brought to you by ilLUminate, the Lehigh Business blog. To hear more podcasts featuring Lehigh Business thought leaders, please visit us at business.lehigh.edu/news. You'll also find links there to follow us on your favorite social media platforms. This is Jack Croft, [music] host of the ilLUminate podcast. Thanks for listening. [music] |