Testimony of

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"Hospital Group Purchasing:
Are the Industry's Reforms Sufficient to Ensure Competition?"

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Mr. Chairman and Members of the Subcommittee:

Good afternoon. I wish to thank you for giving me the opportunity to appear as a witness today in my capacity as University Distinguished Professor of Management and President of the International Center for Corporate Accountability, Inc. (ICCA) at Baruch College of the City University of New York. I would also like to congratulate you on your thorough work on this complex and critical healthcare issue over the last several years and on your obvious determination to ensure free competition in the medical supply marketplace.

As I understand it, my assignment today is to examine the Healthcare Group Purchasing Industry Initiative ("GPO Initiative") and to offer my views on whether it will be sufficient to ensure competition in the healthcare supply industry. This topic has tremendous implications for the delivery of healthcare services in the United States, and I am pleased to be able to share my insights on this matter.

Let me begin by saying that I have spent a large part of my academic career of more than 30 years studying, analyzing, writing and implementing corporate and industry codes of conduct. I have published numerous articles and several books on this topic, most recently Setting Global Standards: Guidelines for Creating Codes of Conduct in Multinational Corporations, which was published in 2003.
At ICCA, a not-for-profit education-research organization based at Baruch, one of our main areas of research has been voluntary codes of conduct or principles, which are being created in increasingly large numbers by corporations and industry groups. We have undertaken numerous studies to analyze their substance and efficacy.
From 1984 to 1991, I worked closely with anti-apartheid groups and multinational corporations in implementing the Sullivan Principles in South Africa, which were aimed at promoting fair employment and eliminating apartheid. This was the most ambitious effort of its kind in my lifetime and involved over 150 U.S.-based multinational corporations. In my opinion, it also happens to be the only truly successful industry code of conduct ever implemented.

Industry-Based Codes of Conduct or Principles
Before looking specifically at the GPO Initiative, I'd like to offer an overview on industry codes of conduct and to discuss briefly the methodology we use at the ICCA for evaluating the substance and efficacy of codes of conduct.

Voluntary industry codes of conduct or principles can potentially play a critical role in engendering public trust in the conduct of an industry. A code of conduct is in the nature of a "private law" or a "promise voluntarily made" whereby an institution makes a public commitment to adhere to certain standards of conduct. The "private law" character of voluntary codes gives the sponsoring organizations a large measure of discretionary action. At the same time, it imposes on them the burden of ensuring that their critics and the public-at-large believe in the institutions' performance claims. In turn, if they are to accomplish that they almost invariably have to create independent systems of performance evaluation, monitoring and verification, and public disclosure.

Extensive studies by ICCA of a large number of industry-wide codes suggest that most of these codes have failed because of the unwillingness or inability of their sponsors to create and implement meaningful codes and standards. This is not surprising, since most industry-based initiatives are created in the aftermath of unethical and illegal activities on the part of the member companies Industry members generally do not go beyond superficial statements of broad principles and a promise to make a good faith effort to improve their performance. Only a handful of industry codes, including those developed by the Forestry Council, electronics industry, and the toy industry, have had any impact at all on the conduct of their member companies. Conversely, oil and gas, mining and defense industries seem to have spent the most money to devise elaborate management and governance systems, but their codes have produced little improvement in the member companies' conduct. In my view, the GPO Initiative falls in the second category.

Based on our research and field work in monitoring code compliance, we have identified eight conditions that must be met for an industry-based code to demonstrate measurable and credible compliance with the industry's voluntary initiative.

1. The code must be substantive in addressing broad areas of public concern pertaining to industry's conduct.

2. Code principles or standards must be specific in addressing issues embodied in those principles.

3. Code performance standards must be realistic in the context of industry's financial strength and competitive environment. The industry should not make exaggerated promises or claim implausible achievements.

4. Member companies must create an effective internal implementation system to ensure effective code compliance.

5. Code compliance must be an integral part of a management performance evaluation and reward system.

6. The industry must create an independent governance structure that is not controlled by the executives of the member companies.

7. There must be an independent external monitoring and compliance verification system to engender public trust and credibility in the industry's claims of performance.

8. There should be maximum transparency and verifiable disclosure of industry performance to the public. Standards of performance disclosure should be the sole province of the code's governing board.

The GPO Initiative

With that as background, I'll now discuss the findings of our study of the GPO Industry Initiative. Over the last six months, my colleagues and I at ICCA have reviewed virtually all of the public record on the GPO issue, including Senate testimony, government and academic studies, legal proceedings, media reports, and relevant industry documents. We have evaluated the GPO Initiative against the principles I've just enumerated. For us, this is the customary process and a necessary precondition for drawing objective and unbiased conclusions.

From our analysis, it is apparent that GPOs play an extremely important role in the healthcare industry, one that is little understood by the general public and even many in the healthcare industry itself. The enormous size of the industry and the buying power it controls would raise anti-competitive concerns under the best of circumstances --

that is, even if the marketplace were operating freely and openly. In the case of GPOs, the potential for abuse is even greater. Our detailed analysis of the public record, which is the basis for my comments, will be contained in a more comprehensive report by the ICCA to be submitted to the Subcommittee later.

This analysis strongly suggests that the current modus operandi of GPOs, doing business under the protection of the Medicare anti-kickback safe harbor, has contributed to a misallocation of a very large portion of the revenue received from vendors in the form of fees and other considerations. Like a spider's web, GPOs engulf both the buyers and suppliers in contractual arrangements that are questionable at best. This control allows them to engage in conduct that illegally and unethically enriches the GPOs at the expense of healthcare providers, new entrants, and the public-at-large. Regrettably, the failure of the industry members to address these issues in the nearly four years -- since this panel first urged them to institute a code to police themselves -- continues the pattern of resistance to change that we have seen time and again with industry codes.

In my professional opinion, the current GPO business model and legal framework has built-in structural flaws, and its financial incentives are so perverse that the GPO Initiative cannot possibly remedy this situation. Anti-competitive contractual arrangements, industry concentration, and especially the vendor-financed fee structure--- all of which arise from the Medicare anti-kickback safe harbor -- have created strong incentives for the GPOs to maximize their income, and equally strong disincentives to distribute this income to their beneficial owners, i.e. hospitals and nursing homes. Indeed, the structure of the new GPO Initiative seems to indicate that its entire purpose is to protect the industry's anti-competitive exclusionary system in which the GPOs' self-interest takes precedence over the welfare of the industry's clients, including healthcare providers, taxpayers, and potential new entrants in the industry.

I do not believe that we can even begin to talk seriously about a GPO Initiative until we have realigned these financial incentives so that the hospitals, and not the vendors, are once again the GPOs' only clients. As long as vendors continue to pay fees to the GPOs, any attempt to create, implement and enforce a code of conduct is doomed to failure.

Creating a new competitive environment will require the repeal of the Medicare anti-kickback safe harbor provision. I might add parenthetically that this provision was a new one for me. As a patient, and as a New Yorker who thought he'd been around the block a few times, I was surprised to learn that there was an industry in this country in which the federal government has essentially continued to protect a system of monopolistic conduct long after the provision had lost any usefulness as an instrument of public policy to improve the economic efficiency of the healthcare delivery system.

Let's now look at the six principles contained in the GPO Initiative. Even a cursory reading of these principles would make it obvious that they urge the member companies to do things that they should have been doing in the first place without the need of a new set of principles. What is missing, and what is needed, is an honest recognition of the member companies' activities that have been found to be inappropriate and a commitment to meaningful and verifiable reform.

I respectfully submit that an objective and thoughtful assessment would conclude that these principles fail to measure up, even at the very minimal level, against any of the eight criteria that I have just described. Among the most serious shortcomings of this Initiative are:

1. There is a total lack of independence in the Initiative's governance structure, which is entirely controlled by the top executives of the member companies. Although the Initiative includes a "coordinator," the coordinator has no real authority.

2. Principles are essentially a statement of intent. Any description of what these principles might contain by way of substance is left entirely to the member companies.

3. Member companies also set their own criteria with regard to standards of compliance, performance evaluation, implementation assurance, and public disclosure. Reduced to its bare essentials, the final product of this process becomes nothing more than a compilation of the reports provided by the member companies based on their own self-evaluation.

4. The governance structure of the GPO Initiative does not provide any mechanism for independent external monitoring and verification of member companies' self-reported performance. Instead, it expects the public to accept this self-reported performance at face value. Such an assertion would be a dubious proposition under the best of circumstances. It would be untenable given the industry's current record.

Conclusion

In summary, the new GPO Initiative is encumbered with a lack of specificity, non- existent performance standards, an internally controlled and self-serving governance structure, and an absence of independent external monitoring system. It is unlikely to yield any meaningful reform. Instead it would exacerbate the problem through absence of meaningful change and would further erode the credibility of its sponsors.

It is unrealistic to expect an industry to create a viable code or initiative that has been operating with a business model based on perverse financial incentives, a questionable legal structure, and federal statutes that undermine the imperatives of competitive markets. Therefore, the repeal of the safe harbor must precede any discussion of a GPO industry code of conduct or initiative.

Restoration of market-based competition would be the first step to create a healthy business model for the entire healthcare industry. While market competition can go a long way in minimizing illegal and unethical practices, it cannot completely eliminate them. This is where industry-wide codes of conduct can potentially play an important role in narrowing the gap between societal expectations and industry performance.

After Congress acts to restore market competition to this industry, I would recommend that the healthcare industry develop a code of conduct that encourages a higher level of ethical and legal conduct. Such a code would adhere to the above mentioned eight criteria for creating and implementing effective codes of conduct. I would urge that such a code not be limited to the GPOs but also include the other two groups in this equation. These are: (i) healthcare providers, i.e., hospitals and nursing homes; and, (ii) the suppliers of medical products and services. As I indicated earlier, a voluntary industry-based code faces an uphill battle under the best of circumstances and cannot possibly succeed unless all parties act in good faith and are truly committed to its success. I earnestly hope that these conditions would emerge once competition has been restored to the healthcare supply industry. This would provide a rare opportunity for the industry leaders, i.e., executives of hospitals, GPOs, and suppliers, to take the lead by creating a truly meaningful code of conduct that would be the role model for other industries.

Thank you for your attention. I would be pleased to try to answer any questions.