ACTIVITY 10.1

SURGEON GENERAL'S TASK FORCE ON THE ECONOMICS OF HEALTH CARE POLICIES

Directions: Imagine that you have been appointed to the Surgeon General's Task Force on the Economics of Health Care Policies. Read the information in Part I about the work of the Task Force. Then read the Memorandum in Part II and respond to the Questions for Discussion.

Part I

In Today's News

The following is a news item from *USA Today*, January 1, 2010, Washington D.C.

Surgeon General to Provide Economic Analysis of Health Care Policies

Dr. Antonio Bonds, Surgeon General of the United States, has nearly reached final recommendations for the President and the nation on health care policy in the United States. The United States, after conducting several state-level experiments, is now ready to adopt a national plan. Dr. Bonds, in turn, commissioned the Task Force on the Economics of Health Care Policies to assist him in reaching a decision.

Dr. Bonds, an economist as well as a medical doctor, has insisted that the members of the Task Force use economic analysis to study health care problems and policies.

Part II

Welcome to the Surgeon General's Task Force on the Economics of Health Care Policies

You have just been appointed by Dr. Antonio Bonds, Surgeon General of the United States, to the Surgeon General's Task Force on the Economics of Health Care Policies. The purpose of the Task Force is to give advice to Dr. Bonds and the nation on how best to improve health care in the United States.

Read the following memorandum from the Task Force Economics Division. This memorandum provides an economic analysis of health care policy in the United States. Discuss the questions that follow.

Economics Division Memorandum on Health Care

To: Members of the Surgeon General's Task Force on the Economics of Health Care Policies

From: Research Staff, Surgeon General's Task Force on the Economics of Health Care Policies, Economics Division

Date: January 1, 2010

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Activity 10.1, continued

Surgeon General's Task Force on the Economics of Health Care Policies

The Fundamentals of Health Care

The fundamental problem we face in health care is that health care is scarce. The resources devoted to the production of health care—the people, hospitals, prescription drugs, clinics, and technology—have potential, valuable uses in other sectors. In other words, while peoples' desires for health care are basically unlimited, the resources needed to provide health care are limited. As a result, we have to make choices about how, and to whom, health care is to be allocated.

The need to allocate scarce resources raises difficult problems. Most goods and services produced in our economy come from the private sector, and most people like it that way. Few Americans would want their condos, cars, or cantaloupes to be produced by the government. But when it comes to health care, people often think differently. To many, the allocation of medical care on the basis of price seems unethical. As a result, many nations with market economies (Canada, Japan, the United Kingdom, and nearly all of the nations of Western Europe) have opted for socialized approaches to medical care.

In many of these countries, hospitals and clinics are operated by the government and paid for by taxes. Physicians, nurses and other health care providers are government employees. Since tax revenues typically do not keep pace with the quantity of health care that people demand when it is provided for them at no direct cost, shortages frequently result. To deal with the shortages, governments develop rules and policies to allocate health care services. The consequence is that patients sometimes must wait in line for important medical procedures.

Demand for Health Care

In the case of shortages and other problems in the health care sector, the laws of demand and supply help to explain what is going on. We should begin by acknowledging that health care is a normal good. This means that as incomes rise, people demand more health care. Per capita income in the United States was $43,500 in 2006. That level of per capita income, by itself, explains in good measure why Americans now demand more and better health care.

Demand for health care is also affected by the notion that it is a necessity. There are few good substitutes for medical care. Thus demand for health care is inelastic. When prices increase for the latest cancer treatment or the newest diagnostic device, many people still want the treatment. Their decisions about expensive treatments are influenced by the fact that they often do not bear all of the out-of-pocket costs.

Since health care is regarded as a necessity, it might seem that we should regard it as different from other economic goods and, therefore, provide for it in a different manner. But health care is not the only necessity about which consumers make choices. Food and housing are necessities, too, but most Americans don't turn to others to manage their purchase of food and housing. They don't ask their employers to pay their rent or buy their groceries. Instead, they decide what sort of housing they wish to have and what sort of food they wish to eat. The concept of necessity does not explain why health care should be thought of as unique.

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Demand for health care in the United States is bolstered by payment methods. American consumers of health care depend heavily on third-party payers. Most families have health insurance paid for, at least in part, by an employer. As a result, they do not feel the "bite," in direct costs, of the health care they consume. Vernon Smith, 2002 Nobel Laureate in Economics, describes it this way:[1]

> A is the customer. B is the service provider. B informs A what A should buy from B, and a third entity, C, pays for it from a common pool of funds. Stated this way, the problem has no known economic solution because there is no equilibrium. There is no automatic balance between willingness to pay by the consumer and willingness to accept by the producer that constrains and limits the choices of each.

Moreover, consumers of health care do not shop around for medical care as they do for other goods and services. They may be deterred from doing so by a sense of urgency about the need for prompt treatment. They may also believe that the information they would need to do comparison shopping is complex and not readily available. And in part, the disinclination to shop is explained by widespread reliance on third-party payers. Why spend time shopping for a low price when somebody else is paying the bill?

Health insurance itself has a special status in the United States. About two-thirds of working adults have health insurance through group insurance programs offered by their employers. The insurance is part of their compensation packages. And it is a form of compensation that is not subject to federal income taxation.

The Supply of Health Care

Like demand, the supply of health care is also influenced by several factors. Among other things, the supply of health care is dependent upon the total number of physicians that are willing and able to offer their services. In the United States, the preparation (education, training, and experience) needed to become a physician makes it very costly to pursue a career as a medical doctor. Medical education ordinarily requires four years of undergraduate college work, four years of medical school, an internship, and perhaps three more years of training in a medical specialization. It is a long, difficult road to take, and, according to an article in the *New England Journal of Medicine,*[2] it has become increasingly expensive over the past several years. Medical school tuition since 1984 has increased by 317 percent at public schools and by 151 percent at private schools. Accompanying this increase has been an enormous increase in the average amount of student debt. The average debt in 1984 was $22,000 for medical students in public schools and $26,000 for medical students in private schools. By 2004, the average debt had increased to $105,000 and $140,000, for public-

[1] Vernon L. Smith, "Trust the Customer!" *The Wall Street Journal*, March 8, 2006, p. A20.
[2] Gail Morrison, "Mortgaging Our Future: The Cost of Medical Education," *New England Journal of Medicine,* January 13, 2005, pp. 117-119.

ACTIVITY 10.1, CONTINUED

SURGEON GENERAL'S TASK FORCE ON THE ECONOMICS OF HEALTH CARE POLICIES

and private-school students, respectively. The high cost of medical education no doubt discourages some capable people from becoming physicians.

Another supply problem has to do with technology. Technology in health care is often very expensive, for a special set of reasons. In other sectors of the economy, when a technological breakthrough occurs and a new product comes to the market, the initial price is usually high. Hand-held calculators and desktop computers, for example, appeared in stores initially as relatively expensive products. In most sectors, however, market forces soon take over and work to reduce prices. High prices early on attract additional producers. Competition increases. Production techniques improve. Supply increases, and prices come down.

In health care, it is different. New technologies in health care often take years to develop, and they are subject to many regulations. Like other new products, they come into the market initially at a high price. But we don't typically see market pressures bringing prices down as quickly in health care as they do in other sectors. Why not? The explanation has to do with the nature of health care, where stakes are high. Consumers facing acute medical problems demand prompt access to the latest technology—the latest robot-assisted surgery, the least invasive treatment for a herniated disk, or the newest cancer treatment. They do not want to wait around for new producers to enter the market, increase competition, increase supply, and reduce prices. This preference by patients is made easier, of course, when someone else is paying for the treatment in question.

The Lack of a Vibrant Market

Supply and demand analysis reveals peculiarities in the market for health care services in the United States. But the fundamental problem is not that health care is provided within a market system. It is that we try to provide health care outside the context of a vibrant, free-market system. In a vibrant market, consumers weigh the price of a good or service against its quality. If the quality isn't provided at the right price, they walk away. Producers pay close attention to these decisions. They innovate to provide consumers with the quality they want at the price they are willing to pay. Providers who are successful remain in business and expand, while providers who are not successful are driven out.

Could such a dynamic operate in health care? Many examples suggest that it could. For example, consumers interested in using contact lenses let it be known early on that they wanted contact lenses that were easy to wear, easy to use, disposable, and inexpensive. Producers such as Johnson and Johnson responded by developing disposable contact lenses. These were a big hit with consumers, and Johnson and Johnson was highly rewarded in the marketplace. Other illustrations can be found in the eye glass industry and, more recently, in the market for Lasik eye surgery. In the Lasik eye surgery market—for a procedure not typically covered by insurance—market forces have driven prices down and generated significant competition among physicians for new customers.

ACTIVITY 10.1, CONTINUED

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So, one of the challenges for this task force is to recommend the adoption of policies that encourage continued innovation in the health care market, but do so in a way that produces high-quality, affordable care for American families. Some of the questions we need to consider are listed below.

Questions for Discussion

1. What is the fundamental economic problem in health care?

2. What sort of health care system do many other market economies provide?

3. Many market economies, such as those in Western Europe and Japan, offer universal health care paid for completely by tax revenues. What is the fundamental advantage of universal health care systems? What is the fundamental disadvantage?

4. Explain two factors that influence demand for health care.

5. Explain two factors that influence the supply of health care.

6. According to the analysts who prepared the Memorandum, is it the existence of a market or the lack of a market that is the problem in health care?

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Activity 10.2

The Surgeon General's Task Force on the Economics of Health Care Policies

Directions: After studying the Memorandum prepared by the Economics Division, the members of the Surgeon General's Task Force on the Economics of Health Care Policies decided that one promising way to improve health in the United States would be to expand coverage to nearly everyone. They also proposed to strengthen market forces in the health care industry. In an effort to meet these goals, the members of the Task Force established four criteria to help them judge health care plans. Read the criteria and the description of the three policy alternatives. Then use the grid to rate the policies according to how well they meet the criteria.

The Criteria

1. **Does the proposed health care policy improve accessibility and reduce the number of people without health insurance?** Any reform for health care must present realistic plans to reduce the number of people who are uninsured. Would the proposed reform, for example, reduce the cost of acquiring health insurance, thus providing an incentive for more people to obtain coverage?

2. **Does the proposed health care policy increase the role of individual consumers in making health care decisions?** Would the proposed reform, for example, reduce the role of third-party payers of health care expenses? Such a move would provide incentives for consumers to economize when it comes to using health care. Plans that shift responsibility for purchasing health insurance from employers to consumers would provide a step in this direction.

3. **Does the proposed health care policy increase price competition?** What incentives are provided to encourage new producers to enter the market? Allowing Americans to buy health insurance from vendors in any one of the 50 states would substantially increase price competition among insurance providers. Would the proposed policy open up opportunities of this sort?

4. **Does the health care policy limit the role of government?** Does the policy set the stage for a government-driven system, or will it lead to market-oriented solutions that will result in a stronger role for consumers and more innovation? Increased health care costs are often cited as a reason to increase the role of government in paying for those costs. Over time, however, governments responsible for health care costs will take steps to control those costs by increasing rules and regulations. The result may be less competition, poorer quality, and unhappy consumers.

The Three Policy Alternatives

1. **Pay or Play.** Some states have experimented with versions of Pay or Play. In this approach all employers are required to provide health insurance for their workers, or pay a special payroll tax or other fee. In Massachusetts, employers must provide health insurance to their employees or pay a fee of $295 per month per full-time employee. In other states, new payroll taxes of about 11 percent are being considered. A state agency would be set up to administer the program.

ACTIVITY 10.2, CONTINUED

THE SURGEON GENERAL'S TASK FORCE ON THE ECONOMICS OF HEALTH CARE POLICIES

2. **Tax Credits.** Other experiments involve providing individuals with incentives to obtain their own health insurance. Here, the federal government would provide a tax credit, for example, of $2,500 for a single person or $5,000 to families, to be used for purchasing health insurance. In another plan for the use of tax credits, the federal government would provide a standard tax deduction for all those who purchase health insurance. In one proposal, individuals would receive a $7,500 deduction and families would receive a $15,000 deduction.

3. **National Health Insurance.** Perhaps the most controversial plan is to establish a system of national heath insurance along the lines of the Canadian plan. In such a system, the federal government would provide a basic package of health care to every individual at no direct charge. The system would be paid for out of tax revenues rather than insurance premiums. While the government would not own heath care facilities such as hospitals and clinics, and it would not directly employ doctors and nurses, it would pay the expenses for all approved medical procedures.

Complete the Decision Grid

Directions: Rate each of the three health care plans (discussed above) according to the four criteria shown in the top row of the grid. For each criterion, rate each plan from 1 to 3, with 1 being the lowest rating and 3 being the highest. Give reasons for your ratings.

	Improve Accessibility	Increase Role of Individual Consumers	Increase Price Competition	Limit the Role of Government
Pay or Play	**Rating:** **Reason:**	**Rating:** **Reason:**	**Rating:** **Reason:**	**Rating:** **Reason:**
Tax Credits	**Rating:** **Reason:**	**Rating:** **Reason:**	**Rating:** **Reason:**	**Rating:** **Reason:**
National Health Insurance	**Rating:** **Reason:**	**Rating:** **Reason:**	**Rating:** **Reason:**	**Rating:** **Reason:**

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