So-Called Market Failure in Health Care

Gilbert Berdine MD

At any national medical meeting, one can usually find one or more discussions about health care economics. Invariably the presenters assert that markets fail for health care. In other words, there is something special about health care that makes it unsuitable to allocation by price discovery. Paul Krugman is a prominent economist. He has been awarded a Nobel Prize in Economics. He writes a regular editorial in the *New York Times*, so his opinions about health care are widely read. On July 25, 2009, he made his case "Why markets can't cure healthcare." [1] Another tactic is to admit that markets are most efficient at allocating scarce resources, but that ideal markets do not exist and the lack of perfect information makes market theory inapplicable to health care.[2] Both approaches rely on uncertainty in "proving" their case against markets. This article will analyze the claims and demonstrate why they are wrong.

Krugman makes two main points. The first is: "One is that you don't know when or whether you'll need care — but if you do, the care can be extremely expensive." Krugman is going to make a case that insurance is necessary for health care, because it is very expensive, and insurance companies are greedy and cannot be trusted to act in the patient's best interest. We will examine Krugman's case step by step.

Is the need for health care uncertain? Some aspects of health care are uncertain. Emergency care for the trauma of a motor vehicle accident would be a good example. Insurance is a very useful tool for such care, but insurance for insurable events are one thing and subsidies for certain needs are quite another. How about annual checkups? This is maintenance. An annual checkup comes around every year like clockwork. There is no uncertainty about an annual checkup. This is not an insurable condition. A very large part of what we call health care is regular and necessary health maintenance. An important first step to solving the mess in U.S. health care would be to properly separate insurable from uninsurable conditions and leave insurance to only the insurable part.

Corresponding author: Gilbert Berdine MD
Contact Information: Gilbert.Berdine@ttuhsc.edu
DOI: 10.12746/swrccc 2014.0208.101

Why is health care very expensive? The last edition of *The Southwest Respiratory and Critical Care Chronicles* explained how government intervention has made U.S. health care inexorably more expensive through regulations and subsidies.[3] So, Krugman is blaming markets for something that is clearly the fault of the same government that he wants to solve the problem. Does evidence support free market theory? In 1962 the Social Security Administration found that the 90% of couples aged 65 and older who had no government health care benefits paid a median annual cost of $442.[4] Based on this survey, Krugman's New York Times lamented that a one week stay in the hospital in 1964 cost $285. By 2010 after nearly 50 years of government "help" along the lines of Krugman's recommendations, a mere single day in the hospital cost $9700.[5] Some of this increase is due to price inflation, but price inflation is just another government failure of meddling with the supply of money. Adjusting for the Consumer Price Index or CPI (using figures from the Federal Reserve[6]) converts $285 1962 dollars into $2005 2010 dollars. This adjustment is not entirely proper since the increase in health care costs are a significant component of the increase in CPI, so the figures overstate the effects of monetary meddling by the government. By any measure a week in the hospital was more affordable in 1962 than in 2010. A one week hospital stay now costs more than the median annual income for a family of four.

Krugman builds his case. "The big bucks are in triple coronary bypass surgery, not routine visits to the doctor's office; and very, very few people can afford to pay major medical costs out of pocket." Why are the big bucks in triple coronary bypass surgery? Medicare chose to reward procedures, including triple coronary bypass surgery, with big bucks while making reimbursement for a routine visit so small that many doctors no longer will see new Medicare patients. Krugman's argument is a little like the child who murdered both parents and begged for mercy on the basis of being an orphan. By subsidizing big ticket items like triple coronary bypass surgery, the government reduces the demand for health maintenance via a mechanism called moral hazard. Moral hazard is a situation where the government reduces the cost for uncertain events in the future which decreases how much people will pay in the present to avoid those uncertain events. If the subsidy for future problems is large enough, as is the case for coronary bypass surgery above the age of 65, there is no reason for people to spend money (or to make unpalatable life style choices) in the present in order to avoid the future consequences.

Having asserted that health care must be unaffordable and that health care has always been unaffordable, Krugman declares that insurance is necessary for health care. "This tells you right away that health care can't be sold like bread. It must be largely paid for by some kind of insurance." As we have seen from the historic record, health care need not be unaffordable and people should be able to pay for health care out of pocket. Medicare has created the "need" for insurance which Krugman is using to justify more Medicare.

Now Krugman will cast the insurance company as the greedy Scrooge McDuck and the government as Mother Teresa. "And this in turn means that someone other than the patient ends up making decisions about what to buy. Consumer choice is nonsense when it comes to health care. And you can't just trust insurance companies either — they're not in business for their health, or yours. This problem is made worse by the fact that actually paying for your health care is a loss from an insurers' point of view — they actually refer to it as 'medical costs.' This means both that insurers try to deny as many claims as possible, and that they try to avoid covering people who are actually likely to need care."

Krugman has obviously never tried to obtain a BiPAP device for someone with chronic respiratory failure. The government demands a sleep study for a problem that has nothing to do with sleep. Insurance has existed for as long as trade. Insurance companies cannot force anyone to purchase insurance. The only way that people will buy insurance is if the company has a record of paying claims. It is true that insurance companies are not charities, but neither is the government. While insurance companies cannot force customers to buy policies, the government can and does with the Affordable Care Act. While insurance companies refer to claims as medical costs, so does Medicare and Medicaid.

Do insurance companies investigate claims? Of course they do. Life insurance companies will not pay claims for suicide. Nor will fire insurance companies pay claims for arson. These are both uninsurable events and the policies explicitly exclude them. Health insurance companies, back when health insurance was still insurance, stratified customers on the basis of actuarial risk. Low risk customers would be charged lower premium. Pre-existing conditions are uninsurable. There is no longer any uncertainty. A person on dialysis is going to have an average expectation for maintenance costs. This average expectation is not an insurable condition. Any insurance policy would have a minimum premium equal to the average expectation and would charge extra for additional risks above and beyond the average expectation. The companies do not want to insure these people because they are uninsurable at the rates mandated by the government. The only solution for long range risks are long term policies that are purchased before the patient develops a chronic disease, but no company will write long term policies when the U.S. Congress changes the rules every year or two. The government has changed health insurance to mean a subsidy for poor health.

Krugman gets to his second point: "The second thing about health care is that it's complicated, and you can't rely on experience or comparison shopping.

('I hear they've got a real deal on stents over at St. Mary's!')" The technical term for this issue is asymmetric information. Asymmetric information is one way that markets can be less than ideal. The solution, contrary to Paul Krugman, is for the market to disseminate the information by one or more mechanisms. These technical problems and how the market is best able to deal with them will be discussed in the next installment.

Author Affiliation: Dr. Gilbert Berdine is a pulmonary physician in the Department of Internal Medicine, TTUHSC.
Received: 8/31/2014
Accepted: 9/24/2014
Reviewers: Benjamin Powell PhD
Published electronically: 10/15/2014

References

1. http://krugman.blogs.nytimes.com/2009/07/25/why-markets-cant-cure-healthcare/?_php=true&_type=blogs&_php=true&_type=blogs&_r=1
2. http://www.ncbi.nlm.nih.gov/pmc/articles/PMC3210041/
3. http://www.pulmonarychronicles.com/ojs/index.php?journal=pulmonarychronicles&page=article&op=view&path[]=143&path[]=353
4. http://www.ssa.gov/policy/docs/ssb/v27n7/v27n7p3.pdf
5. http://www.hcup-us.ahrq.gov/reports/statbriefs/sb146.pdf
6. http://www.minneapolisfed.org/community_education/teacher/calc/hist1913.cfm