

This is a sample of the instructor materials for Thomas Rice and Lynn Unruh, *The Economics of Health Reconsidered*, Fourth Edition.

The complete instructor materials include the following:

- A 102-page instructor's manual
- PowerPoint slides for each chapter

This sample includes the instructor's manual pages and PowerPoint slides for Chapter 3, "Assumptions Underlying the Competitive Model and Implications for Markets and Government."

If you adopt this text, you will be given access to the complete materials. To obtain access, e-mail your request to hapbooks@ache.org and include the following information in your message:

- Book title
- Your name and institution name
- Title of the course for which the book was adopted and the season the course is taught
- Course level (graduate, undergraduate, or continuing education) and expected enrollment
- The use of the text (primary, supplemental, or recommended reading)
- A contact name and phone number/e-mail address we can use to verify your employment as an instructor

You will receive an e-mail containing access information after we have verified your instructor status. Thank you for your interest in this text and the accompanying instructor resources.

Digital and Alternative Formats

Individual chapters of this book are available for instructors to create customized textbooks or course packs at XanEdu/AcademicPub. Students can also purchase this book in digital formats from the following e-book partners: BrytWave, Chegg, CourseSmart, Kno, and Packback. For more information about pricing and availability, please visit one of these preferred partners or contact Health Administration Press at hapbooks@ache.org.

Chapter 3: Assumptions Underlying the Competitive Model and Implications for Markets and Government

Overview

This chapter sets the stage for the remainder of the book by listing 14 assumptions, culled from various authors, on which the belief of the superiority of markets in the health sector is based. Each of these assumptions, however, is taken up in detail in subsequent chapters, so they are not discussed here.

Concepts

- As noted in Chapter 1, one cannot demonstrate the superiority of one healthcare system over another solely through the use of theory. But theory is important, as it provides guidance as to the anticipated effects of particular policies, behaviors, and actions. Of the 14 listed assumptions of the competitive model, some are standard fodder in microeconomics textbooks (e.g., consumer information is good, firms do not have monopoly power) while others are less often noted, although not necessarily less important (e.g., a person is the best judge of his or her own welfare, consumer tastes are predetermined, the distribution of wealth is approved of by society). The book argues that few, if any, of them are met in the healthcare area, which implies that the standard recommendations that fall out of the standard economic model (e.g., increase patient cost sharing to reduce welfare less) may not work well in the healthcare sector.
- Health economics deals with both positive and normative issues (although these terms are not used explicitly in the chapter). Testing a positive issue (e.g., does more cost sharing reduce utilization?) is a fairly straightforward task, but this is not so for a normative issue (e.g., is competition or regulation a better approach?). The field of *welfare economics* focuses on normative issues. Graaff (1971) contends that the only way to test such issues is by examining the validity of the assumptions on which they are based. That is the tack taken throughout the book. To illustrate, one key set of assumptions is that consumers can use available information successfully to maximize their utility. We must examine the validity of this assumption to make conclusions about the advisability of relying on markets in areas where consumer information is particularly problematic—as is the case in most of health services.
- Much of the book is devoted to the failure of markets in healthcare. However, government can fail, too. It is not clear which of these failures—markets or government—is a greater problem. This determination can be made only empirically, by examining the success of different countries' healthcare systems, some of which rely more on markets and others more on government. We do that in Chapter 12. But it is not an all-or-nothing question: All countries use both markets and government to varying extents. The issue, then, is finding the

appropriate mix, taking into account differences in the values that each country brings to the table.

- There is an extensive literature on government failure, from the fields of both economics and political science. In economics, this literature sometimes goes by the term *economics theory of regulation* or *capture theory*. In political science, the terms *public choice theory* and *rational choice theory* are used. In contrast with *public interest theory*, where it is assumed that regulations benefit consumers, these alternative theories are much the opposite: Regulation is suggested by, and benefits, the groups that are regulated.
- A particular challenge facing government is the role of special interest groups. Economists and political scientists, through the economic theory of regulation and public choice theory, have highlighted the potential of government being captured by special interests. These theories have been subject to various criticisms, particularly that they do not do a good job of predicting certain behaviors (e.g., voting, legislators who act on their ideals). Nevertheless, they have been important in alerting us to the potential for capture.
- No matter where one comes down on which theory better explains the politics of healthcare (and obviously, this choice varies by issue and by country), capture theory and similar theories have helped raise society's awareness of government's potential for serving special interests rather than consumers.

Discussion Questions and Suggested Answers

- (1) One of the assumptions listed in Exhibit 3.1 is that consumers have sufficient information to make good choices. Suppose that this is not the case in the hospital market. In fact, many people go to hospitals to have procedures with which the hospital has relatively little experience and has achieved relatively poor outcomes. In what ways does this situation imply that relying on market forces is not resulting in the best outcomes? What sorts of tools or policies could be used to rectify this problem?
- If consumers have poor information about the hospital market, they may choose to go to a hospital that is (a) more costly than others and/or (b) provides poorer quality care.
 - Consumers might benefit from well-publicized websites, created by objective sources, that provide comparative data across hospitals on costs for typical procedures, the quality of care provided, and consumer satisfaction with that care.
 - Alternatively, government might “regionalize” care so that certain hospitals specialized in certain (elective) procedures. All patients who needed a certain type of care would be directed to the appropriate hospital. A problem with this

solution, however, is that it would provide these hospitals with monopoly power—an issue taken up in Chapter 6.

(2) If government is in charge of enacting and enforcing regulations, and if government officials are either elected or appointed by those who are, why is regulatory capture a problem? Should not voters simply vote out of office those who abuse their authority?

- The main problem is that voters are concerned with numerous issues. When they elect their legislators, they cannot focus on everything, and the issues they do focus on are usually more general (e.g., the economy, wars). In contrast, special interest groups can focus all of their attention on a single issue and direct resources/contributions to legislators who can support their cause. Legislators can support these causes, usually without losing the support of the electorate, which may not even be aware of the issues supported by the interest groups.

(3) The economic model of regulation, in which special interest groups capture government regulators, contrasts with a “public interest” model in which government in general, and regulators in particular, serve consumer interests. Who are the most important special interest groups in the health sector? How do their interests align with those of consumers?

- There are probably more special interest groups in healthcare than in any other part of the US economy. They are too numerous to list. On the provider side, prominent groups include the American Hospital Association, the American Medical Association, and the American Nurses Association. On the product side, the Pharmaceutical Research and Manufacturers of America is particularly prominent. Insurance is now represented by America’s Health Insurance Plans. There are many consumer groups as well, perhaps the most prominent being AARP.
- The provider and product special interest groups are not expected to represent consumers; that is not their constituency. This does not mean, however, that there are not areas of agreement. All groups, for example, often lobby toward increasing the quality of care provided.

Further Reading

(1) Graaff, J. de V. 1971. *Theoretical Warfare Economics*. London: Cambridge University Press.

This book is one of the classics on welfare economics. It is short and readable but more oriented toward the PhD than the master’s or undergraduate student. The introductory and conclusion chapters provide good summaries of the challenges of making welfare (normative) conclusions, but within the book there are also useful discussions of such things as Pareto optimality and externalities.

(2) Stigler, G. J. 1971. “The Theory of Economic Regulation.” *Bell Journal of Economics and Management Science* 2: 3–21.

This article was the original piece on the economic theory of regulation. Stigler argues that politicians maximize their utility by providing regulatory protection to special interest groups, which in turn provide either monetary contributions or other ways in which politicians can garner votes for reelection. Consumers are essentially powerless because they are concerned about many issues and cannot focus on particular regulations with the same intensity as can the special interest groups.

(3) Peltzman, S. 1976. “Toward a More General Theory of Regulation.” *Journal of Law & Economics* 19 (2): 211–40.

This article extended Stigler’s work, providing a more nuanced economic theory of regulation. In Peltzman’s theory, consumers can act as an interest group, too. As noted in footnote 6 of the chapter, politicians and other regulators reach equilibrium by equating the ratio of marginal benefits to marginal costs across competing interest groups.

(4) Wolf, C., Jr. 1993. *Markets or Governments: Choosing Between Imperfect Alternatives*. Cambridge, MA: MIT Press.

This book discusses the advantages and disadvantages of different degrees of markets vs. government involvement in various policy issues.

ASSUMPTIONS UNDERLYING THE COMPETITIVE MODEL AND IMPLICATIONS FOR MARKETS AND GOVERNMENT

The Economics of Health Reconsidered, 4th ed.,
Chapter 3



CHAPTER OUTLINE

- ◎ Critical assumptions of market competition in healthcare
 - ◎ Demand for health, insurance, and services
 - ◎ Externalities of consumption and the formation of preferences
 - ◎ Degree of competition in healthcare
 - ◎ The profit motive in healthcare
 - ◎ Equity and redistribution in healthcare
- ◎ Overview of welfare economics
- ◎ Government can also fail
- ◎ Markets vs. government: a false dichotomy



CRITICAL ASSUMPTIONS OF MARKET COMPETITION IN HEALTHCARE

- ⊙ Demand for health, insurance, and services
 - ⊙ A person is the best judge of his or her own welfare.
 - ⊙ Consumers have sufficient information to make good choices.
 - ⊙ Consumers can accurately predict the results of their consumption decisions.



CRITICAL ASSUMPTIONS OF MARKET COMPETITION IN HEALTHCARE

- ⊙ Demand for health, insurance, and services
 - ⊙ Individuals are rational.
 - ⊙ Social welfare is the sum of individual utilities.



CRITICAL ASSUMPTIONS OF MARKET COMPETITION IN HEALTHCARE

- ⊙ Externalities of consumption and the formation of preferences
 - ⊙ There are no negative externalities of consumption.
 - ⊙ There are no positive externalities of consumption.
 - ⊙ Consumer tastes are predetermined.



CRITICAL ASSUMPTIONS OF MARKET COMPETITION IN HEALTHCARE

- ⊙ How competitive is the supply of healthcare?
 - ⊙ Supply and demand are independently determined.
 - ⊙ Firms do not have any market power.
 - ⊙ There are not increasing returns to scale.



CRITICAL ASSUMPTIONS OF MARKET COMPETITION IN HEALTHCARE

- ◎ The profit motive in healthcare
 - ◎ Organizations maximize profits.
 - ◎ Profit maximization results in the most efficient production and the highest consumer welfare.



CRITICAL ASSUMPTIONS OF MARKET COMPETITION IN HEALTHCARE

- ① Equity and redistribution
 - ② The distribution of wealth is accepted by society.



OVERVIEW OF WELFARE ECONOMICS

- ◎ Welfare economics is concerned with how a society can best organize itself to improve the well-being or welfare of its citizenry.
 - ◎ Should we rely on competitive policies in the health services sector?
- ◎ Why not just look at the evidence?
 - ◎ Sometimes there is no direct evidence because there is no historical precedent.
 - ◎ Given the same data, different analysts reach different conclusions.



WHY WELFARE THEORY IS SO IMPORTANT

“[W]elfare . . . is not an observable quantity like a market price or an item of personal consumption [so] it is exceedingly difficult to test a welfare proposition. . . . The consequence is that, whereas the normal way of testing a theory in positive economics is to test its conclusions, *the normal way of testing a welfare proposition is to test its assumptions.* . . . The result is that our assumptions must be scrutinized with care and thoroughness. Each must stand on its own two feet. We cannot afford to simplify much.”

– Jan de V. Graaff



IMPORTANCE OF THEORY (CONT'D)

- ① To get health economics theory right, it is essential to study the validity of the assumptions of market competition.
- ① Otherwise, one may miss policy options that could enhance social welfare, many of which cannot be derived from the conventional economics model.



GOVERNMENT CAN ALSO FAIL

- ⊙ “Economic theory of regulation”
 - ⊙ Politicians attempt to maximize self-interest by retaining power, which requires votes and money.
 - ⊙ Special interest groups will provide this if they are offered something tangible in return.
 - ⊙ That “something” is often regulation that helps the group’s members (e.g., prevent competition from potential new entrants, price subsidies, actions that harm those selling substitute goods).
 - ⊙ Consumers are powerless to counter this because their interests are too disparate.
 - ⊙ Applies to regulatory agencies as well, which may need to keep special interests happy to legislators fund their budgets.

GOVERNMENT FAILURE (CONT'D)

- ⊙ Criticisms of economic theory of regulation
 - ⊙ Do public officials generally act in such a self-interested manner?
 - Is there no role for ideology in politics and the civil service?
 - ⊙ The theory sometimes does poor job predicting behavior—e.g., why would people vote in elections when they almost surely won't influence results, or vote to raise their own taxes?
 - ⊙ Nevertheless, the theory helps raise awareness of government's *potential* for self-serving behavior, and where such failure is most likely to be manifested.



THE FALSE DICHOTOMY BETWEEN MARKETS AND GOVERNMENT

- ⊙ All countries rely on both; societies must determine where each is most appropriate and how best to mix the two.
 - ⊙ Markets improve on government by helping ensure that consumer demands are met and resources are not squandered.
 - ⊙ Governments improve on markets by ensuring that poor and sick individuals have access to care and that providers and insurers do not unreasonably profit from selecting healthier patients.
- ⊙ The book argues that the assumptions in this chapter made market solutions seem more effective than they actually are in solving key problems in healthcare.