

Why governments
regulate the health
care industry
economics essay



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In the first part of the essay we define market failure and look at the model of perfect market, we then compare this with health care market and find out the causes or factors that results in failure in the health care market. In the second part we will look at the ways governments in four different countries have intervened to ensure that the causes of the market failure are corrected.

Market failure can defined as a situation whereby there is a failure to achieve an efficient allocation of resources within the market economy.

A fundamental problem with the concept of market failure, as economists occasionally recognize, is that it describes a situation that exists everywhere (Nelson, 1987; Dahlman, 1979).

There are different kinds of market that exist in the society with the perfect market and monopoly at the extremes and the others in between this spectrum.

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Perfect Market

The perfect market model also referred to as a perfect competition is the most important model because it serves a benchmark from which other kinds of market can be viewed. The main objective of any firm in the market is to maximise profit and the price of the goods and services are determined by market forces. The perfect market is based on the following assumptions;

There is full information,

The transactions are impersonal,

There are no barriers to entry or exit,

There are many buyer and sellers, and they cannot influence the market price,

The products are homogenous which means that the buyers cannot differentiate between products.

Finally the goods are private goods.

Why is health care market different?

The first reason for this is that health care is a public good which is different from a private good as seen in the perfect market model, public good has two features, non-rivalrous which means that the use of it by one person does not stop another from benefitting from it, and it is non-excludable this means it will difficult to prevent people from enjoying the benefits. With public good there is what is known as a free-rider problem – people will not pay for them because others are willing to pay for them. The nature of public

goods poses a problem for the market because the private sector will not make a profit from their provision since everyone can enjoy it whether they pay or not. Health care is also a public good and under provision of it also leads to market failure. Health care is also a merit good that society values and believes that people should have them because consumption is believed to generate positive externalities-this will be discussed in the next paragraph as well as other causes of market failure.

Causes of market failure in health care

1. Externalities

Externalities also referred to as third-party effects occur when others are affected by the transaction arising from the production and consumption of health care for which the costs or benefits are not taken into account." The core of the argument against market failure analysis is derived from the study of transactions." (Zerbe et al p7). Whenever there is a transaction externalities are known to occur which leads to transaction costs. This is defined as " the resources necessary to transfer, establish and maintain property rights". The property rights was developed by R H Coase where he stated that individuals form firms to reduce transaction costs. Externalities may arise in different ways and they may be either positive (beneficial) or negative (harmful), and can be during production or consumption. Examples of negative externality is smoking which results in external costs on a third party - passive smoking and also alcohol ingestion can lead to antisocial behaviour. Vaccination against infectious diseases is a form of positive externality where an individual is certain of protection by the consumption of another person. An example of external cost of production is via pollution <https://assignbuster.com/why-governments-regulate-the-health-care-industry-economics-essay/>

from an industry and external benefits of production is the patent rights given to firm that discovered a new drug, stopping all other firms from copying the products. When there are externalities in health care this will not lead to a perfect market hence market failure will occur. The externalities discussed so far can be referred to as selfishly motivated. There is externality referred to as caring externality which occurs when individuals get personal satisfaction from knowing that a person is getting the health care they need. Externalities are around us every day but they are not taken into account whenever there is a transaction, this is because property rights are not well defined. Health care is not owned by anyone so therefore there is economic incentive to protect it and the only way the property rights can be well defined and protected will be through government regulation e. g. by banning smoking in public places and also making vaccinations compulsory. Even with government legislation it is difficult to achieve this. (Zerbe, 1976, 1980; Medema and Zerbe, 1999a), in a world in which property rights are fully specified and in which transaction costs are zero, the allocation of resources will be efficient. This kind of world does not exist, this is an indication that market failure will always occur.

2. Imperfect information

“ Economics is concerned with the efficient use of limited productive resources for the purpose of attaining the maximum satisfaction of our material wants” (Jackson and McConnell, 1985, p3), this involves transacting parties utilising these resources to meet and satisfy their wants. This is based on the assumption that the parties have full information about the goods and services being bought or sold and also about each other. These <https://assignbuster.com/why-governments-regulate-the-health-care-industry-economics-essay/>

assumptions describe a market where there is perfect information (Stiglitz, 1993). In the health care there is imperfect information and/or information asymmetry. Information asymmetry can be defined (using the acquisition of health insurance as a classical example) as situation whereby client that wants to get a health insurance has more detailed information about himself than the insurance company. Imperfect information is the case of a physician who has more knowledge than patients. The uncertainty of illness and the cost of it when it arises is one the principal reasons for taking health insurance. Two problems arise whenever there is insurance cover; these are adverse selection and moral hazard. Information asymmetry and adverse selection was first described by George Akerlof in his article, " The market for lemons: Quality, Uncertainty and the Market Mechanism. Adverse selection is often referred to as a hidden information problem in a market, where for example sellers may know more about a product than a customer. (Estrin and Laidler). During the 1980s, when HIV/AIDS was first discovered insurance companies suffered from adverse selection as a lot on individuals with this disease took increased insurance cover without disclosing their status. This led to the suggestion that genetic testing should be used for individuals who may wish to acquire health insurance. The concept moral hazard was first defined by the French economist Dreze in 1961 (Mooney 1994, p 135), but it is often described as a hidden action because it results in behavioural changes in patients once their expected losses are covered by health insurance. Ehrlich and Becker (1972) distinguished between ex ante and ex post moral hazard. The former occur in a healthy state when individuals can engage in preventive care such as regular exercises and good eating habits and the latter when the individual is ill, but since the <https://assignbuster.com/why-governments-regulate-the-health-care-industry-economics-essay/>

health be it taxation or other forms of health insurance which allows a subsidise price or free at the point of use, there is a greater demand by the patient than it will be if the patient was to pay all the costs. Donaldson and Gerard (1993, p 31), comments, " thus, the market fails to transmit efficient price signals to consumers".

Donaldson and Gerrard (1993) identified two types of provider moral hazard. They identify moral hazard by doctors who are identifiable actors in the health care system and also moral hazard by hospitals. Doctors are known to act on behalf of the patients both as the demander and supplier of services and do not account for the cost. First on the supply side they are the provider of health care and on the demand side there is information asymmetry. There are different reimbursement which affects doctor's attitudes and two that affects the patient's attitudes (charges to patients, private practice). Provider moral hazard occurs most commonly with the fee-for-service (FFS) reimbursement - doctors are paid on the quantity of services; more services will result in a higher income. Therefore there is a financial incentive for physicians to provide care in excess of what the patients may require if they had full information. There is not much literature on hospital moral hazard so this can be an area for future development.

3. Imperfect competition

The perfect market provide the best means of making sure that the economy is efficient by encouraging firms to compete and also creating choice. These conditions for efficiency serve as a benchmark to help identify sources of allocative inefficiency referred to as ' market failures'. But in the real world

the perfect market does not exist as Hausman argued, “ when taken literally, the notion of market failure is of little relevance, because perfectly competitive equilibrium, the benchmark against which market “ fail”, does not obtain. Despite this the competitive market have been used on the assumptions on which it was formed, as Amelia Fletcher, Director of Markets and Policies Initiatives commented, ‘ Competition is a rivalrous process, in which firms compete effectively to give the consumers a better deal’. The question is that is this obtainable in health care with the uncertainty that surrounds ill health? The first problem here is the limited information has about the outcomes and benefits of various medical treatments. Individuals rarely have the same illness over time so there is little opportunity to acquire information and even on those with long standing chronic illness like diabetes who may have information. The changing world of advanced technologies means that there will be information disparities. Oligopoly is the dominant market model in health care and McPake and Normand (2008, p 141) noted, “ the key feature of an oligopoly is that the decision made by one firm depends on the decision made by other firms, i. e. there is a high degree of interdependence between firms”. Thus there may be incentives for hospitals to collude which results in adverse outcomes for the society. It is generally accepted that competition works best when there is excess capacity, but in health care there is excess demand.

4. Inequality and poverty

An individual ability to purchase health care depends upon his income to a large extent. In standard economic theory it's the ability and willingness to pay that determines how resources are maximally utilised but this does not

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happen in the real world as we have noted from previous sections in this essay. Goodwin (2005) commented that, hospitals make demand and other raw materials from suppliers with the expectation that the final products will be bought by consumers-the demand by consumers are those backed by the consumer's ability to pay. So what is important in a perfect market is effective demand i. e., there is distribution of resources to meet the basic human needs. Therefore if for example few wealthy people desire a particular commodity and many poor people lack money to purchase basic health needs then the market will be stimulated to create those commodities for the rich, hence the market will fail.

Government intervention and regulation of health care market

From our discussion it can be seen that intervention is necessary to counteract the causes of market failure as well as the consequences such as adverse selection and moral hazard.

Boadway and Wildasin (1984, p 61) suggest that, " while typically the remedy for market failure due to public goods is for the public sector to provide the good, the remedy for externalities is often to provide incentives to the private sector to produce the correct amount".

We will examine detailed evidence from four countries: the United Kingdom (UK), the United States of America (USA), France and Finland to ascertain how they intervene and regulate their health care systems.

Methods of government intervention

1. State provision

One of the main ways of solving market failure is through public funding of the health service. In the UK, France and Finland hospitals are funded through taxes but in UK it is through general taxation while France and Finland use a social insurance system. This system ensures universal coverage for the population, prevents exploitation of patients by monopoly of providers. The main problem is the issue moral hazard which is more common in publicly tax funded system in UK than the social insurance system of Finland and France. In the UK the issue of moral hazard is controlled by using gatekeepers, waiting lists, waiting times. In France and Finland price mechanism is used to deter moral hazard. Compared to the USA where it is more of private insurance, co-payments, deductibles and medical savings account schemes have been used as ways of reducing moral hazard. Donaldson and Gerard (1993, p 72) argued that, " even the US health care system recognises the shortcomings of a total reliance upon market forces. The main form of government regulation there is in the form of insurance schemes for elderly people (Medicare) and indigent people (Medicaid)". But in the USA, adverse selection is very common and it also occurs in UK but to a lesser extent, but this is almost non-existent in the social insurance system (France and Finland).

2. Taxation and subsidies

Imperfections in the market lead to inefficient allocation of resources and this leads to negative or positive externalities. Taxation is used to discourage certain behaviours like monopolising and overpricing and subsidies can help

to reduce the cost of paying for merit goods like health care. Governments in all four countries for example in order to reduce the negative externalities caused by smoking introduced taxes for the purchase for cigarettes and also legislate that companies should advertise the dangers of smoking on the pack of cigarettes sold. Antitrust legislation are passed in all four countries e. g. law prohibiting the formation of monopolies and preventing imperfect competition.

3. Regulation

Dolan and Olsen (2002), commented that there is constant pressure for more spending in most health services around the world, therefore policy makers have to impose regulatory measures on the providers of services to achieve efficient allocation of the resources. Regulation can be through price control, quality control e. t. c. Regulation of pharmaceuticals is one area where most of government intervention occur, for example in the UK, the National Institute of Clinical Excellence(NICE) issues guidelines on which drugs are approved and can also be used. Also sets a ceiling on how much the cost should be but one main disadvantage is that it can exclude the use of new and effective treatment because of the costs. In USA there is the Food and Drug Administration (FDA) which also a regulatory body. In France there is the Agence Francaise de Securite Sanitaire des Produits de Sante (AFSSAPS), and in Finland the National Agency for Medicines.

4. Cost benefit analysis

Government intervention must take into account the cost benefit analysis, if the benefits are more than the costs. Then the government should collect taxes and provide the good.

Government failure

Government failure can occur when mechanisms put in place to improve the market failure worsens the situation and lead to inefficiency and inequity in the health care and also create distortion. The following can result in government failure;

1. Inefficiency of State provision

In all four countries political self interest can lead to inefficiency and worsen the market failure already present because politicians can design policies to retain power rather than maximise efficiency. In France and Finland the taxation is usually higher and results in more expenditure and in the UK the citizens do not know how much is been used for health care and other sectors of the economy.

2. Changes in government policies

In the USA insurance firms can find it difficult to plan without knowledge of taxes, subsidies e. t. c and this will lead to inefficiency.

3. Free markets usually leads to more efficient provision of health care(USA as an example) which allows the law of demand and supply to determine how the market works

4. Lack of incentives

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Undesirable incentives usually create inefficiencies, for example in France where doctors are paid by salary in some hospitals this will lead to inefficiency.

5. Lack of information

Government can lack information just as much as the market because most times the government do not know what kind of health care the consumer really needs and provides this based on the information they have and may not even know the full costs/benefits of the policy.

6. Bureaucracy

Most times procedures of the government are usually cumbersome and this cuts across all the four countries. Governments respond more slowly to changes and also the time it takes from planning to implementation may cause policies to be ineffective.

Conclusion

Market failure is known to exist in all market economy and the health market is not an exception. It has been shown that there reasons why health care market may not work efficiently, thereby necessitating government intervention. Health care is a public good and coupled with the externalities and information gaps are causes of market failure which requires correction but a sufficient justification for government intervention.

Intervention is known to be costly, so therefore for it to be effective a cost-benefit analysis to suggest it is worthwhile needs to undertaken to avoid government failure which lead to market failure in itself.