Health economics essay sample

Health & Medicine

ASSIGN BUSTER

Introduction;

The study of health economics is concerned with analyzing the functions of the health care systems in regards to the scarcity and in the allocation of health care. There are two factors that separate the health care economics and the rest of the countries economics. First, the government, which also tends to be the biggest player in the market, extensively regulates the market [Phelps, 1963]. Secondly, in this sector, there’s usually the issue of asymmetrical information, externalities and intractable uncertainty [Arrow, 1963]. This paper seeks to explore the agency relationship between the patient and the clinician with an aim of showing that this relationship is responsible for market failures in the health industry sector.

Asymmetrical information; the physician in most cases has significantly more information about a disease or general health than the consumer. The knowledge gap gives the physician a distinct advantage over the consumer. The ideal situation in a free market would have been that of perfect information; this is a situation where consumer has all the information about all the products at all time; and is therefore able to choose the best product in the market and at the right time.

Uncertainty; the very nature of the health care system deals with conditions whose outcome cannot accurately be predicted; this include both the outcome of the condition and financial issues

Externalities; when considering the health care industry, various externalities arise. The susceptibility and occurrence of disease, for example can be greatly affected by behavioral trends such as exercising, smoking and

practicing safe sex. This will affect other people apart from the maker of the decisions.

There are several topics that make up the study of health economics; these include the demand of health care, the supply of health care, definition of health and its value, economic evaluation of treatment and the influences to health; system equilibrium and planning and budgeting [Williams, 1987].

What is market failure?

Before we delve into the causes of market failure in the healthcare industry, we must first define what it is. Market failure is the situation that occurs when a free market is operating efficiently in terms of allocation of resources leading to the loss of economic efficiency. This results in the market not being able to deliver maximum benefit to the society.

Market failure occurs when the party supplying a product to the market is getting returns that are proportional to the returns the society s getting thereby resulting in the sub-optimal supply of the product in the market.

Basically, market failures occur where individual act purely on self-serving sentiment resulting in outcomes that are not seen to be beneficial to the society in terms of efficiency of resource allocation. Market failures are usually seen in public goods; also in non-competitive markets such as monopolies.

An ideal market, that is, one that operates at maximum efficiency of allocation of resources has to have perfect information; this state would allow for perfect competition; the consumer will be able to choose the best

product in the market, thus rewarding such a product with higher sales and penalize poorly produced and priced merchandise with low sales; thus the allocation of resources and the setting of prices will be determined by pure competition. With time, the supply of the latter product in the market will reduce due to low demand and the market will only have products that the consumers want and at prices they are willing and able to pay. The market will have no shortages or surpluses; thus making it efficient in allocation of resources.

Market failures are usually seen in public goods, such as healthcare, and the government usually has to step in and regulate the market so that everyone can benefit; and to forestall public health crises that would resort in a collapse of such a market. In such a case, not everyone that consumes the service pays; for example, the National Health Service in Britain offers universal healthcare to all persons regardless of their paying capabilities. As such, it has to delve into public coffers to sustain such a market.

Health care demand:

Health care as a product has a peculiarity in that resources can be allocated by an individual both to produce and consume health. The aim of the consumer is to enlarge the stock of health capital. The Grossman’s model of health production views an individual both as a consumer and producer of health. If the health is treated as stock, the model suggests that lack of investment in health results in degradation of the stock [Grossman, 1972]. The consumer benefits from the products of health care by the satisfaction gained from using the facilities during a medical case. On the other hand,

the consumer also has to invest some resource to improve the productivity of the program; for example, to maximize on reduced susceptibility to disease, the consumer can invest in exercise and healthy diet.

The health care market consumer:

In the health care market, the consumer tends to have little information about the type and quality of the health care services that they need to buy; and which of the service provider gives the best package for the same amount of payment; thus the market lacks perfect information. Basically, when a consumer visits a health care institution, he or she cannot dictate the kinds of medical products that s/he prefers, depending on their cost and benefits; since it’s only the medical professionals who know these intricacies. The health care provider can therefore give treatment recommendations based not on medical criteria but on an economic one; for example, a doctor can choose to prescribe a certain drug due to its better profit margins over the other brands. This kind of practice results in a supply induced demand. Another effect of asymmetry of information is in practice variations; in this case rather than the condition of the individual being the sole determinant of the type of treatment he or she receives, which doctor they visit also comes in to play a part.

Market failures:

There are five health markets that are usually studied. They include; physician and nurses services market, healthcare financing markets, professional education market, input factors market and institutional services market. The prices in the US markets are usually set by the market

forces through competition. This has resulted in the reduction of prices. The service providers have tried to reduce this effect through consolidation to reduce competition. The formation of these monopolies especially in the insurance industries put barrier in the financial market; this can result in the failure of this market since health care ceases to be a private good; this is a failure of the healthcare financing market. Additionally, one cannot generally assume that there is perfect information about price products; this is especially from the physicians who have the double role of being the suppliers of the product and the person determining the supply in the market; such would lead to a failure of the physician and nurse's services market since the consumer cannot make a completely informed choice on the best quality and priced product in the market.

Agency relationship thus causes market failure of both the service and financing markets.

AGENCY RELATIONSHIPS:

The term physician agency is used to describe the issues that arise from the physician's influence on health care [McGuire, 2000]. In the health care industry, there is a three way relationship; this is between the individual, the physician and the insurers. The most important among these bonds is between the consumer and the physician; the relationship is arguably complicated.

The general suspicion in the health care industry is that the physician agency exists purely for the purpose of generating profits from the interaction with the consumer. However, other than for profit maximization,

the relationship is influenced by other factors such as ethics, altruism, current practice, motivation, power and medical training. The relationship serves therefore to cater for both the profit targets of the physician and the welfare of the patient. The medical treatment of the patient is determined exclusively by the physician; therefore all the payments and the reimbursements made by the insurance companies are set by the doctor. The insurers have recognized that the physicians motives are not purely profit oriented since the welfare of the patient is also important to them; consequently, they have come up with measures to control how much money a doctor can spend on a patient in order to minimize their payments; these quantity control measure include quantity limits, utilization reviews and restrictions.

Market failure;

Market failure occurs when a free market fails to deliver Pareto efficiency. Pareto efficiency occurs when after allocation of the resources, it is impossible to make anybody better off without making another worse off.

Market failure occurs in health care when the product ceases to be a private good. As such issues of non-excludability and non-rival consumption arise. The former arises because it is not possible to exclude non-paying consumers from the market; the latter from the fact that consumption by one consumer does not deny the resource to another consumer in the same market. Market failure is thus a situation where a force outside the market (such as a government) has to move in to finance the consumption of a service for the welfare of the public. as such, since a section of the market is

able to enjoy the benefits of the service at no cost, less and less consumers will be willing to pay significantly reducing effective demand and precipitating a breakdown of the market and requiring the entry of non-market force to remedy the situation. For a market to function optimally, the market forces of demand and supply have to be allowed to set the prices in the market; and to exclude non-paying consumers from the market.

Arrow [1963] identifies four causes of market failure in the health care industry; externalities, lack of information, risks and uncertainties and supplier induced demand.

Externalities; using the word “ non-marketability”, Arrow describes a situation where an individual is not required to pay for the costs that he or she has imposed on others as a result of his or her actions; or does not permit the individual to collect the benefits from his actions. For example, if a person is suffering from a communicable disease and goes ahead to refuse treatment, diagnosis or vaccination, and still remains an active threat of disease to others, then he not only risks his own health but also of others without suffering any costs on this. The consequence of this is that the market does not have all the accurate information concerning the benefits and costs of the market transaction. To remedy this, Arrow envisioned three things that can be done to prevent market failure. First of all, subsidies to encourage the individuals to remove the externality from the market can be used; for example, free vaccination against the communicable disease can be done. On the other hand, instead of rewards for removal, there can be penalization for perpetration; for example, the effects of smoking not only affect the primary smoker, but also endanger the people who inhale

secondary smoke. To remedy this, increased taxation on cigarettes and tobacco can be instituted. A final method of remedying externalities is through compulsion. Enforceable regulations for mandatory (for example vaccination of children) can be done. This will remove the possibility of any individual bringing in an externality in the market.

From the description of externalities by Arrow, some economists have gone ahead to divide externalities into selfish and caring externalities [Paris Uni, 2009]. The scenario described by Arrow can be categorized as selfish. When an individual receives a benefit from knowing that other people are getting medical care, this can be classified as caring externality. The practice of having collective way financing minimum health coverage for everyone is an example of caring externality.

Lack of information can also cause market failure; in the health care industry, the consumer is usually unlikely to have information to enable him or her to fully appreciate the full range of medical possibilities available to them. For a free market to operate effectively it is necessary for the consumer to have the ability to get the right goods and at the lowest price possible: this can only occur if the market is able to transmit all the information concerning the benefits and the costs between the consumer and the producer; that is, perfect information. Lack of this flow of information leads to market failure. The physicians are the main source of personal and medical information for both the patient and the insurer. The latter can enter into agreements to fund medical care of the patient without knowing the full extent of the patient’s condition and prognosis; this is not in their best interest as their main aim is to provide medical cover at the lowest

cost possible. The market fails when the insurers are no longer willing or able to enter into these agreements that do not favor them financially.

Risks and uncertainties; the occurrence of disease is unpredictable and the severity of it cannot be speculated before hand. This, coupled with the expensive nature of health care can be a cause of market failure. Additionally, since one cannot predict the outcome of a disease, buying of healthcare also carries a risk. The fact that the medical care products cannot be tested before-hand and their quality assessed by the consumer before purchasing; does not improve the situation. If a market lacks insurers to bear especially the long term risks of health care, then a market could fail. It was Arrows opinion that non-market social institutions should move in and bridge this gap to forestall such a failure.

Uncertainties also include the issue of Supplier induced demand; the health care market is a peculiar one since it is the producer that is the care provider, who decides the type and amount of product, that is, the treatment, the patient consumes. This is because the patient lacks the necessary medical knowledge to make such decisions for him/herself. Additionally, some of them are passive patient who do not seek second opinions on the cost of their health care; thus the doctor will have the first and the last say. The drive to make more profit by the producer can give rise to the temptation to exploit the consumer by advising excess or more expensive treatment for the patients. The consequence of this is the generation of a supplier induced demand that is unnatural to the market and can lead to its failure. For Arrow, there were three factors that can mitigate this phenomenon.

First the physicians' behavior is supposed to be governed by the concern for the welfare of the consumer and by professional ethics. The physicians are also bound and dictated by a system of licensure and a professional code of practice; the breaching of these regulations is accompanied by punitive measures such as deregistration or fines. Finally, the development of health care institutions that are not driven by profit-making goals can be another solution; these will have no reason to exploit the consumer since they are non-proprietary. For example, in the UK, the National Health Service offers universal cover for all citizens; this is a point-of-delivery free service where anyone can walk in and get served. However, since this market is not driven by free-market forces of demand and supply, then it cannot function as efficiently as a free market. Thus, there arises a debate of universal access with rationing versus limited full access. By providing cover for everyone, paying and non-paying, the market has limitations to what services it can provide; thus few people may suffer or die as the system cannot offer some expensive procedures while many people benefit from the resources through many other relatively cheaper procedures and treatments. Thus through rationing, the British government manages to provide healthcare t a relatively lower price than an open market plagued with asymmetrical information and prone to failure.

DISCUSSION:

From the reasons outlined by Arrow, it is clear that there is more than one cause of failure of the market. However, agency relationships between the consumer and the physician have been blamed for market failures in the health industry.

The reasons why the consumer enters into an agency relationship with a physician has been outlined. First, the choice made by the consumer may have fatal consequences for him or her. Secondly the consumer does not have enough information to make such choices. The consumer thus prefers passing the choice to the physician. The transfer of choice of goods or services from the consumer to the producer marks the beginning of the agency relationship. With this scenario, then the question on the sovereignty of the consumer arises. In an ideal market, the consumer must have the power to make knowledgeable and rational decisions about the products they want to consume, to judge the cost of the product, to bear the cost of the product, to judge the benefits of the product and to receive those benefits. Agency relationship in the healthcare industry no doubt takes away some of this privileges from the consumer and significantly reduces his sovereignty; this sets the stage for a failure of the market. The agency relationship also sets the stage for other phenomena that are harmful to the market; for example, the creation of a supplier induced demand.

CONCLUSION:

Since the healthcare industry is extensively regulated by the government, the most of the factors that are potentially harmful to the market can be controlled. For example, the government can set exit barriers on the healthcare insurers to protect the consumers from a failure of the market.

On the other hand, there exists little or no regulation to control the effects of the agency relationships in the healthcare industry from affecting the market. Taking the discretion of choice from the consumer to the producer, it

is impossible to analyze whether the physician is acting as the consumer would if the consumer would have a similar range of information about the practice of medicine. Since the producer is in the market to make profit, the question whether s/he has the financial incentive to provide low cost medical service while at the same time having the discretion of choice is nagging.

These effects of the relationship force by the insurance providers to place restriction on the type of patient they are willing to cover and to what extent; this effectively locks out some consumers from the market setting off the process of market failure.

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