



The Economics of Health Care

Full Length Text — Part: 6 Chapter: 8
Micro Only Text — Part: 4 Chapter: 5


To Accompany “Economics: Private and Public Choice 12th ed.”
James Gwartney, Richard Stroup, Russell Sobel, & David Macpherson
Slides authored and animated by:
James Gwartney, David Macpherson, & Charles Skipton

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Structure of the Health-Care Industry


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Expenditures on Health Care

- U.S. expenditures on health care have soared from 5.2% of GDP in 1960 to 9.1% in 1980 and 16% in 2005.
- **Medicare** and **Medicaid** were established in the mid-1960s .
 - **Medicare** covers the bulk of the hospitalization expenditures of the elderly.
 - **Medicaid** covers health-care expenditures for those with low incomes.
- Medicare & Medicaid spending have soared.
 - Even after adjusting for inflation, **Medicare expenditures** in 2005 were 11 times the figure for 1970.
 - Real **Medicaid spending** in 2005 was 15 times the level of 1970.

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The Growth of Expenditures on Health Care

Health-Care Expenditures as a share of GDP (including both private and government)

Year	Expenditures as a share of GDP
1960	5.1 %
1970	7.0 %
1980	8.8 %
1990	12.0 %
2005	16.0 %

- Since 1960, health-care expenditures have grown to become a larger and larger share of the U.S. economy.

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The Growth of Expenditures on Medicare and Medicaid

Real Expenditures on Medicare and Medicaid (billions of 2005 dollars)

Year	Medicare (billions of 2005 dollars)	Medicaid (billions of 2005 dollars)
1966	~10	~5
1970	~20	~10
1980	~50	~30
1990	~100	~60
2000	~250	~150

- As shown here, real expenditures on both Medicare and Medicaid have soared during the last several decades.

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Socialized Health Care

- In many countries, health care is a socialized industry. Hospitals & medical clinics are run by the government and financed by taxes.
- Doctors, nurses, and other medical personnel are government employees.
- No country is wealthy enough to provide *unlimited* free health care to all.
 - When price plays a secondary role, non-price factors such as waiting lists and the absence of expensive treatments will be present.
- Wealthy patients in countries with socialized medicine often travel to other countries for treatment unavailable in their home country.

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Structure of Health Care in the U.S

- Both private and government operated enterprises are important in the U.S. health-care industry.
- Physician services are generally provided privately;
- Hospitals are often operated by local governments.

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Structure of Health Care in the U.S

- More than 85% of U.S. health-care spending is paid for by a third party, either the taxpayer or a private insurance company.
- Medicare and Medicaid cover the bulk of the health-care cost of the elderly and the poor.
- Health insurance is highly important for the non-elderly.
 - About two-thirds of the non-elderly have health insurance through their employer.

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Structure of Health Care in the U.S

- The U.S. tax system favors the purchase of health insurance through employers (*it does not count as income*) and discriminates against both direct payment of medical expenses and the out-of-pocket purchase of medical insurance (*neither is tax deductible*).
- This discriminatory tax treatment
 - encourages employees to demand and employers to provide low-deductible, small co-payment health insurance policies, and,
 - discourages direct payment of medical bills and the purchase of high-deductible insurance plans.

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Third Party Payments and Health-Care Inflation

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The Growth of Third-Party Medical Service Payments

- Both the tax system and the Medicare and Medicaid programs have contributed to the growth of third-party payments.
- In 2006, third-party payments accounted for 85% of the medical-care purchases, up from 44.8% in 1960.
- Out-of-pocket spending of consumers accounted for only 15% of health-care spending in 2006, down from 55.2% in 1960.

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The Growth of Third-Party Payments

Out-of-pocket versus Third-Party Payments for Medical Care

Year	Public	Private health insurance	Out of pocket
1960	23.4 %	21.4 %	55.2 %
2006	49.1 %	35.9 %	15.0 %

- The share of medical expenses covered by a third party (either insurance or the government) and the share paid directly by the consumer are shown here for both 1960 and 2006.
- Note the growth of the third-party payments.

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Subsidies, Third-Party Payments, and Health-Care Inflation

- Economic theory indicates that the growth of subsidies to health-care consumers and expansion in third-party payments will push the prices and expenditures of medical services upward.
- Growth of subsidies, like those provided by Medicare and Medicaid, will increase the demand for medical care. The stronger demand will lead to higher prices, particularly if the supply is inelastic.

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Subsidies, Third-Party Payments, and Health-Care Inflation

- Growth of third-party payments reduces the incentive of both consumers and producers to economize.
 - Consumers have less incentive to economize because someone else is paying the bill.
 - Producers have less incentive to economize because consumers are insensitive to the prices charged.

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Ratio of Health-Care Price Indexes to the Consumer Price Index

Respective Health-Care Index (relative to the CPI)

Year	Medical care	Prescription drugs
1960	1.0	1.0
1970	1.1	0.8
1980	1.2	0.5
1990	1.5	0.8
2000	1.8	0.9
2006	2.2	1.0

- Since 1960, the prices of medical services have risen twice as rapidly as the general price level.


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Subsidies, Third-Party Payments, and Health-Care Inflation


- In summary, both subsidies and third-party payments have pushed health-care prices upward.
- The rising health-care prices and expenditures are not surprising. They are an outgrowth of the policies and changing incentive structure of the last four decades.

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Is the U.S. Headed for A Health-Care Crisis?

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The Future

- As the baby boom generation begins to reach age 70 during the years following 2015, the elderly population of the U.S. will grow rapidly.
- The growth of the elderly population during 2015 – 2035 will increase both subsidy levels and third party payments. Under the current structure, this will push both health-care prices and expenditures upward.

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Growth in the U.S. Population Age 70 and Over: 1995-2035

Number of Americans Age 70 and Over (millions)

Year	Number of Americans Age 70 and Over (millions)
1995	23.8
2005	26.6
2015	31.2
2025	43.9
2035	58.0

- The growth rate of the elderly population will accelerate as the baby boomers move into the retirement phase of life during the years following 2010.
- This will make it very difficult to control the growth of health-care prices and spending.

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Averting the Crisis: How to Move Toward A Consumer Driven System

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Health-Care Reform

- Several Reforms would help avert the crisis that will occur when the baby boomers retire:
 - Equalize the tax treatment of out-of-pocket medical expenses and the direct purchase of health insurance with that of health insurance purchased through the employer.
 - Encourage *health savings accounts* (HSAs) and direct payment of medical bills from such accounts.

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Health-Care Reform

- Several Reforms would help avert the crisis that will occur when the baby boomers retire:
 - Encourage the purchase of catastrophic health insurance and discourage the purchase of policies with first-dollar coverage and small co-payments.
 - Shift Medicare from a reimbursement service to a defined-benefit plan (at least partly).
 - Place more emphasis on the supply side of the health-care market.

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Questions for Thought:

1. Why have the prices of medical services risen so much more than other prices during the last several decades?
2. Does it make any difference whether medical services are paid for directly by consumers or by a third party such as the government or an insurance company? Why or why not?
3. "Low deductible health insurance coverage encourages health-care consumers to search for the best prices."
-- Is this statement *true or false*?

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Questions for Thought:

4. "If consumers do not have much incentive to shop for value per dollar of expenditures on medical services, producers will not have much incentive to keep prices low."
-- Is this statement *true or false*?
5. Currently, health insurance purchased through an employer is tax deductible (it is not counted as taxable income), while the direct purchase of health insurance and payment of medical expenses is not. Do you think this is sound policy? Why or why not?
6. When an employer provides health insurance benefits as part of the compensation package, does this represent a gift by employers to their employees? Why or why not?

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