Healthy Competition: What’s Holding Back Health Care and How to Free It

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Introduction: What Can Competition Do for Patients?

Health care in the United States is not what it should be. For one thing, it seems to grow less affordable each year. Official reports tell us that prices for medical care consistently rise faster than prices for nonmedical items. In particular, health insurance premiums are rising faster than both inflation and earnings, and are thus taking up a growing share of family budgets. Without health insurance, families risk enormous medical bills in the event of serious illness or injury. Yet tens of millions of Americans have no health insurance, either because it has become too expensive or isn’t worth the price. Government spending adds a number of very large (if somewhat hidden) items to the nation’s health care bill.

The burden of paying for health care is only part of the problem. It also seems that health care quality is not always as high as it should be. America is a leader in medical innovation. Many Americans receive the best care available anywhere in the world, and many foreigners visit America to take advantage of cutting-edge medicine. However, a surprising number of patients receive substandard care. Substandard treatment can actually increase costs—both the costs associated with prolonged illness and the costs of additional care. Uneven quality—high quality in some areas, lower quality in others—seems to persist over time, in part due to a lack of information on providers and services. Employers, insurers, and government officials are just now beginning to take notice of the fact that substandard care may be partly responsible for rising health care costs.

Furthermore, patients seem to be losing control over their health care decisions. Health care is not like other goods and services. It exists to extend life and reduce pain. Many patients would value being able to make their own health care decisions, with the advice of their doctors, more than they value being able to choose their own cars, car insurance, or computers. Yet Americans have fewer choices when it comes to health insurance than they do with car
insurance. Employers have been making decisions about Americans’ health insurance for as long as anyone can remember. Government also makes many health insurance decisions for consumers, particularly senior citizens. In recent years, employers and insurance companies have begun making what amount to treatment decisions as well. Managed care probably does eliminate some unnecessary costs. But patients resent the lack of choice this entails, and doctors resent the intrusion on their professional judgment. Impediments to patient choice crop up in other corners of the medical marketplace, such as laws that prevent terminally ill patients from choosing their own courses of treatment.

These are vexing problems. Quality, affordability, and choice seem to present tradeoffs: getting more of one seems to involve getting less of the others. On the one hand, employers, insurance companies, and government can set limits on what treatments they will cover. This may eliminate low-quality care. But it also reduces patient choice and would sometimes block access to necessary care. On the other hand, if patients are given free rein, what’s to prevent them from overutilizing the health care system or choosing low-quality care and imposing costs on everyone else?

How can high-quality health care be made affordable, without sacrificing patient choice? That is a question asked over and over again in health policy circles. It underlies debates over health insurance, prescription drugs, primary and preventive care, hospital care, and aid to the poor. And it has stumped policymakers in Washington and the state capitols for generations. The thesis of this book is that the way to find solutions to the vexing problems of America’s health care system is through a competitive market process. We do not claim to know any particular solution to these problems. We do, however, propose a method of discovering them.

**Why Competition?**

Competition is a tool for finding answers we don’t have. At the beginning of each baseball season, opinions run strong about which club has assembled the strongest team. But we do not know, and will not know, which team is the best until the regular season, playoffs, and World Series winnow the field to one. (Even then, there can be passionate disagreement over the result. That is why we have next season.) Competition puts to the test both the product
(the ball club) and people’s opinions (“The Cubs will win the pennant this year—I guarantee it”).

If we had answers instead of just opinions, competition would be unnecessary. As the late Nobel laureate Friedrich Hayek wrote, “In sporting events . . . it would be patently absurd to sponsor a contest if we knew in advance who the winner would be.”\(^1\) The reverse is also true: it would be silly to hang a gold medal on someone because we believe she is the fastest runner. Without a race, how could we know? It is the race that gives us the answer; the contest tells us what we want to know.

The same is true of scientific discovery. It would make little sense to ordain that Newtonian physics is the only way to understand the universe and to forbid competing theories. Nor would it make sense to allow only one person or school to offer and test such theories. What if the ordained theory or scientists were wrong? And how would we know whether they were wrong without allowing others to offer criticism and alternative theories? In science, the truth emerges in time through a competitive process. “Competition,” Hayek explained, “must be seen as a process in which people acquire and communicate knowledge.”\(^2\) Competition is how society acknowledges that it does not have the information it wants, and demonstrates that it is serious about discovering it.

Competition plays a special role in economics, including health care. Scientific discovery typically pursues immutable, unchanging facts. Economic competition searches for information and answers that are constantly changing. What is the best way to lower the price of health care and increase quality? How many doctors does the United States need? Or hospitals? Or magnetic resonance imaging (MRI) machines? In what parts of the country are these most needed? What should the prices be for MRI services? Can some tasks that are usually performed by physicians be performed as reliably by other medical professionals? What is the best way to ensure that drugs are safe and effective? Where should drug manufacturers focus their research? The answers to these questions change constantly as technological advances, demographics, and other factors produce changes in available resources and societal needs.

As a result, Hayek argued, finding the answers to economic questions is an ongoing process requiring constant experimentation and learning. Unlike a footrace, economic competition never quite arrives
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at a final answer. It keeps revealing the new “best” answer in an ever-changing world. Economic competition is not merely the bustle of greedy businessmen trying to make a buck, although it certainly can be that. More important, Hayek wrote, it is “a discovery procedure” that constantly provides and adjusts information that we cannot know, and therefore cannot use, without a competitive process.³

What has to be in place for market competition to provide us with these answers? First and foremost, market competition requires a wide pool of competitors and potential competitors, including entrepreneurs with new ideas. Finding the answers to the prior vexing questions requires capturing and using knowledge as diverse and dispersed as

- whether patients are waiting too long to see specialists in Tallahassee,
- what type of health coverage matters most to the near-elderly in Spokane, and
- how to make primary care hassle-free.

These bits of information—and ideas on how to use them—are scattered across vast numbers of people. Therefore, individuals must have maximum latitude to apply their knowledge and ideas to meet these changing needs. Open competition gives entrepreneurs that latitude, and thus calls forth information and ideas from all corners. That suggests that competitive health care markets should have low barriers to entry, and that entrepreneurs should have the flexibility to experiment with new ideas.

Second, a competitive market needs some mechanism to evaluate each producer’s ideas and efforts. Such a mechanism is most useful if it constantly feeds information to each producer about how much value she is providing consumers. The obvious feedback mechanism is consumers themselves.

Information about available health care resources is dispersed among millions of producers and potential producers. Likewise, information about what consumers value is stored in the minds of hundreds of millions of consumers. Allowing consumers to make their own health care decisions is a way of capturing and conveying that information. When consumers are free to choose the health care services they want, that information is transmitted to both favored
and disfavored producers through the customer’s purchasing decision. Individual choice is particularly important when we consider that different people have different values. When economic decisions are made by a mechanism other than individual choice, many consumers’ preferences will go unnoticed and their needs unmet.

Having consumers weigh different options against one another is a necessary part of discovering what consumers value. If consumers can choose only one of two options, they will choose the one that provides them the most value. That information is then captured and used by producers. But if patients have their freedom of choice taken away, or are allowed to consume medical care for “free,” things change. In such cases, the market cannot learn what they value most. If they face no tradeoffs, they likely will consume medical care that they do not value very much. Those resources are then not available to meet other social needs. A competitive health care market needs consumers who are free to choose from competing options and who face tradeoffs among competing options.

When these conditions of a competitive market are met, individual choice actually promotes lower prices and higher quality. Since consumers desire both, they will naturally choose the combination of health insurance and medical services that gives them the best mix of both. When innovations come along that provide greater value—that is, higher quality and/or lower prices—consumers will gravitate toward those new options. The result is a market process that makes health care of ever-increasing quality available to an ever-increasing number of consumers.

Unfortunately, when it comes to health care, government has long behaved as if it knows all the answers. Through laws and regulations, it has claimed that it knows the best way to provide medical care for workers in their retirement. It has picked one form of private health insurance that should be favored before all others. It claims that it knows the only way to protect the public from unsafe medical technologies, and that it knows the best way to finance medical care for the needy.

Year after year, government continues to choose “winners” in the medical marketplace. Each time it does, it hampers the competitive process that reduces costs and increases quality. People often claim that government must step in because a particular question is too important to be put to the test of competition. (Often, the same
people have a personal interest in what they claim is the “right” answer.) Nonetheless, even when entry, innovation, consumer choice, and market valuation are hampered, competition relentlessly tries to break through its restraints.

**Competition and Health Care**

The evidence is all around us. In markets where consumers are free to choose from numerous producers, competition reduces prices and makes products of ever-increasing quality available to an ever-increasing number of consumers. Michael E. Porter of Harvard University and Elizabeth Teisberg of the University of Virginia write,

In healthy competition, relentless improvements in processes and methods drive down costs. Product and service quality rise steadily. Innovation leads to new and better approaches, which diffuse widely and rapidly. Uncompetitive providers are restructured or go out of business. Value-adjusted prices fall, and the market expands. This is the trajectory common to all well-functioning industries—computers, mobile communications, banking, and many others.4

However, they continue,

Health could not be more different. Costs are high and rising, despite efforts to reduce them, and these rising costs cannot be explained by improvements in quality. Quite the opposite: Medical services are restricted or rationed, many patients receive care that lags currently accepted procedures or standards, and high rates of preventable medical error persist.5

Porter’s and Teisberg’s description of health care markets is accurate, although not uniformly. In health care markets where consumer choice and competition are free to operate, they deliver higher quality and lower prices just as they do in other markets.

Consider drugs, for example. A study by University of Pennsylvania economist Patricia Danzon found that prices for generic drugs are typically lower in the United States than in eight other advanced nations, while over-the-counter drugs are “considerably cheaper” in the United States. Danzon attributes that to “the relatively unregulated, more competitive structure of the U.S. market.”6 Although Danzon finds that pioneer drugs are more expensive in the United States (at least while under patent), a study by Tufts University finds
that when multiple drugs are approved for the same indication, competition dramatically lowers the cost of those drugs as well. Cholesterol-lowering statins introduced in 2003 cost 45 percent less than those introduced 10 years earlier. Anti-hypertensive drugs introduced in the mid-1990s cost 72 percent less than those introduced in the early 1980s.7

Cosmetic surgery is another area where choice and competition deliver higher quality and lower prices. In that market, patients pay directly and therefore must weigh the costs and benefits of each procedure. As a result, inflation-adjusted prices have fallen every year from 1992 to 2001.8

Patients also weigh the costs and benefits of laser eye surgery, another highly competitive market where prices have fallen dramatically. As Figure 1 demonstrates, the average price for Lasik surgery in 1999 was about $2,100 per eye. Within two years, it had fallen to less than $1,600 per eye.9 Many patients pay less.10 The price of refractive surgery dropped even more relative to overall inflation and medical inflation. Were Figure 1 to adjust for quality improvements—a driving factor behind recent price increases—it would
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show that average prices have fallen even more dramatically. It is also notable that these falling prices occur despite the fact that more than 80 percent of Lasik patients search for an experienced surgeon with a strong reputation, rather than just the lowest price.\textsuperscript{11}

Consumer choice and competition are even making urgent medical care more accessible. In a growing trend,\textsuperscript{12} hospitals in such countries as Argentina, Barbados, Costa Rica, India, Malaysia, Singapore, and Thailand are competing with hospitals in countries with long waits for treatment or high health care costs. In 2003, an estimated 150,000 foreign patients traveled to India for medical care.\textsuperscript{13}

For example,

\begin{itemize}
  \item In 2004, North Carolinian Howard Staab had no health insurance when his doctor told him he needed open-heart surgery. Durham Regional Hospital told Staab the procedure would cost $200,000. Instead, Staab flew to New Delhi where Dr. Naresh Trehan—formerly a professor at New York University Medical School—performed the operation at Escorts Heart Institute and Research Center for less than $10,000.\textsuperscript{14}
  \item Tom Raudaschl, a mountain guide and Canadian resident suffering from osteoarthritis, found he would have to wait as many as three years for a hip resurfacing operation in Canada or pay $21,000 for the procedure in the United States. Apollo Hospitals in Chennai, India, performed the operation for less than $5,000.\textsuperscript{15}
  \item The same choice spared Terry Salo of British Columbia a painful year’s wait for hip replacement surgery.\textsuperscript{16}
  \item Robert Beeney, “a 64-year-old real estate consultant from San Francisco,” paid $6,600 for a hip joint resurfacing in Hyderabad, India. The procedure was not covered by his health insurance and would have cost him $25,000 at home.\textsuperscript{17}
  \item To obtain coronary bypass surgery from the National Health Service in his native England, 73-year-old George Marshall would have had to wait more than six months. At a private British hospital, the procedure would have cost him $38,000. Marshall commented, “At 73, I don’t have the time to wait . . . Six months could be the rest of my life.” Instead, Marshall underwent surgery in Bangalore, India. The total cost including travel expenses was $8,400. Marshall remarked that under Britain’s NHS, “you are just a number,” while at Bangalore’s Wockhardt Hospital, “you are a person.”\textsuperscript{18}
\end{itemize}
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Foreign hospitals aggressively compete with each other (and U.S. hospitals) on the basis of price and quality. Apollo promises what one report describes as “First World health care at Third World prices.” Cardiac and orthopedic surgeries often cost one-fifth to one-quarter the U.S. price, more than enough to cover the cost of airfare and lodging (which some hospitals will arrange). In Indian hospitals, orthopedic procedures cost one-fourth, and cataract surgery can cost one-tenth, the price in U.S. hospitals. Dr. Trehan claims that Escorts charges $60 for an MRI, compared with $700 in New York.

Trehan also claims his Escorts Heart Institute and Research Center posts lower death rates from heart surgery than New York-Presbyterian Hospital, where former president Bill Clinton received bypass surgery. The reason? “Our surgeons are much better.” A British-trained pediatrician in India’s Apollo Hospitals commented, “Nobody even questions the capability of an Indian doctor, because there isn’t a big hospital in the United States where there isn’t an Indian doctor working.”

International competition is also lowering the cost of processing health insurance claims, interpreting the results of diagnostic tests, and conducting clinical trials for new drugs.

Here at home, competition delivers similar results—where it can be found. A study by Stanford University economists Mark McClellan (now the head of Medicare and Medicaid) and Daniel Kessler found that in the 1990s “competition among hospitals was unambiguously welfare-improving.” Compared with less competitive markets, the cost of treating heart attack patients in competitive hospital markets was lower, readmission rates were lower, and survival rates were higher. The authors found that “competition had the potential to improve [heart attack] mortality by 4.4 percent” and suggested that competition likely produced similar benefits in other areas of hospital care.

In a subsequent study, Kessler and Jeffrey Geppert found that greater competition between hospitals leads to a better match of resources to needs. Severely ill heart attack patients receive more intensive care in competitive hospital markets than they do in less competitive markets, and those treated in less competitive markets “have significantly worse health outcomes.” When it comes to less severely ill heart attack victims, however, something changes. Those
patients receive more intensive treatment in less competitive markets than they do in more competitive markets. Yet the added expense produces no improvement in health outcomes. Kessler and Geppert’s findings suggest that competition eliminates unnecessary costs and moves resources to avenues where they are needed and where they will deliver results.

In these examples, competition is lowering prices and improving quality. Why are these successes the exception and not the rule? The answer is that in America’s health care sector, a dense thicket of laws and regulations disables the competitive process that produces such outcomes. Government discourages patients from shopping for value and encourages them to disregard costs. It pays doctors and hospitals according to volume with no regard to quality. It restricts the choices available to patients and blocks competition among providers of medical goods and services. Through tax policy, subsidies, and regulation, government reduces patients’ freedom to choose, reduces competition, and obstructs the market processes that deliver higher quality at lower prices.

Even where competition can be found in America’s health care system, Porter and Teisberg argue, much of it takes place at the wrong level. Instead of providers competing for patients, one finds health plans, hospitals, and provider networks competing for the business of bureaucracies that purchase care on behalf of patients. A major report by the Federal Trade Commission and Department of Justice confirms that competition in the U.S. health care system is badly hampered:

> Competition has affected health care markets substantially over the past three decades. New forms of organization have developed in response to pressures for lower costs, and new strategies for lowering costs and enhancing quality have emerged. Nonetheless, competition remains less effective than possible in most health care markets, because the prerequisites for fully competitive markets are not fully satisfied.

The agencies recommend encouraging patients to become more prudent health care consumers; realigning the self-interest of providers with patients’ interest in low-cost, high-quality care; reducing government barriers to competition among medical professionals and facilities (e.g., hospitals); removing barriers to interstate competition;
targeting government subsidies directly to patients; and reducing regulations that increase the cost of health insurance.

Many take America’s high and rising health care costs as a sign that health care is a special case in which consumer choice and competition do not work. Stanford University’s Alain Enthoven has written, “A free market does not and cannot work in health insurance and health care . . . If not corrected by a careful design, this market is plagued by problems of . . . market failure.”

Yale University professor George Silver, who was deputy assistant secretary for health under former president Lyndon B. Johnson, writes, “Today’s dysfunctional health care system is a palpable example of the lessons that come from our national obsession with markets at all costs.”

Yet this view fails to account for the pervasive influence of government in the U.S. health care sector, and how that influence stifles market competition. According to Danzon, “Government is more pervasive in health care than in almost any other industry.” By at least one measure—the share of expenditures financed directly by patients—health care in the United States is more socialized than in other nations with explicitly socialized health care systems. Government directly finances health care for more than one-quarter of the U.S. population (77 million people in 2003), or nearly half of all health expenditures. It heavily influences all other medical expenditures, sets prices and other terms for countless health care transactions, and prevents many exchanges and arrangements that would benefit both parties, either through outright prohibitions or by refusing to uphold contracts. Columbia University law professor William Sage notes that many have “ignored this reality and indulged the belief that U.S. health care is a private system governed by private competition.”

The fact that the United States still has the most market-oriented health care system among advanced countries says more about how little other nations rely on choice and competition in health care than about how much the United States does so.

**Competition vs. Controls**

America faces a choice between two approaches to meeting the nation’s medical needs: greater choice and competition in an open marketplace, or more government control. Ultimately, the decision
is between competing visions of whether power in the medical marketplace should reside with individuals or with government.

In December 2003, President George W. Bush signed into law a piece of legislation that embodied both options. Beginning in 2006, the “Medicare Modernization Act” will add outpatient prescription drug subsidies to the Medicare program, taxing working Americans to provide prescription drugs to the elderly and disabled. This legislation represents the largest expansion of government influence in the health care arena in 40 years. With the stroke of a pen, President Bush imposed unfunded obligations on current and future taxpayers that are greater than the unfunded obligations of the entire Social Security program (see Chapter 6).

While the new Medicare prescription drug subsidies will reduce choice and competition in one area of America’s health care sector, health savings accounts (HSAs) will restore these natural market forces in another. The Medicare Modernization Act created HSAs beginning in January 2004. HSAs represent a milestone in health care policy, for they help restore the right to choose one’s doctor and one’s health insurance, to own one’s health insurance policy, and to save for future medical needs. HSAs replace the perverse incentives involved in paying providers on the basis of volume with sensible incentives that result from paying providers on the basis of value. HSAs encourage providers to compete for individual patients rather than health plans and networks, as Porter and Teisberg recommend. HSAs represent a significant departure from the prevailing culture of health care in America, focusing producers’ attention on the needs of consumers, and all parties on the need for greater economy and innovation.

Although a modest reform on their own, HSAs have revolutionary implications. They return government health policy to what must be its first principle: the right of individuals to make their own health decisions. Yet fully restoring the freedom of patients and doctors requires more than health savings accounts. Fulfilling this vision requires respecting the right of Americans to choose for themselves:

- whether to purchase health insurance and what type;
- how to finance their health care needs in retirement, rather than be forced into a government-controlled scheme;
• how to assist the medically needy, rather than be forced to finance often unnecessary and harmful “charity” care;
• whether to try an experimental treatment;
• what type of medical professional to consult; and
• whether to choose a different level of malpractice protection than courts would apply.

It also requires respecting the right of medical professionals to choose their areas of practice, to run their practices as they choose, and to innovate, all free from unnecessary government obstacles.

The principles of consumer choice and competition that underlie health savings accounts can be applied to all areas of the medical marketplace: the taxation of health expenditures, government subsidies, regulation of medical providers and products, and the medical liability system. In each of these areas, lawmakers should increase the number of decisions made by individuals and decrease the number of decisions made by government officials. This includes removing outright restrictions on the freedom of patients, providers, and taxpayers, as well as laws that reward or punish Americans for the decisions they make about their health care. The key principles can be distilled down into two maxims:

(1) Congress shall make no law encouraging or hindering particular methods of medical care, or of financing medical care.
(2) The right of the people to contract for medical goods and services shall not be infringed.

Past patients’ rights legislation has consumed reams of paper in an effort to restrict the number of choices individuals may make about their health care. These maxims have a different goal: to expand the choices available to patients, and to affirm the patient’s right to choose. Health savings accounts represent a first step toward this vision of a free-market health care system.

The alternative vision would restrict freedom by maintaining or expanding government influence over America’s health care sector in the pursuit of greater health, equity, or consumer protection. Though usually well-intentioned, measures that expand government’s influence often achieve the opposite of these goals. Worse, this vision produces harms that reach beyond the realm of economics or even that of health. It demeans the dignity and diversity of the
American people for government to deny them the freedom to care for their minds and bodies according to their own judgment.

A health care system free of any special involvement by government will give pause to many. To some extent, health care is a special area of public policy. In many instances, it is essential for survival. Americans oppose the idea that some people might suffer because they cannot afford medical care. Many Americans believe government must play a special role to protect patients from the errors and predations of health care practitioners and corporations.

Yet government’s presence in the medical marketplace extends far beyond what can be justified by the desire to help in hard cases. By hindering the competitive process, government actually makes it more difficult for the medically needy to obtain care. Americans’ aversion to allowing the needy to go without medical care is an indication both of the American people’s compassion and what America might achieve with a health care system free of unnecessary government influence. Ultimately, the very fact that health care is often a matter of life or death is the most powerful argument for reducing government’s influence over its provision. This is one of the themes that the remainder of this book explores.

This book is organized as follows. Part I examines the state of America’s health care system, acknowledging the things it does well, dispelling certain popular misconceptions, and finally addressing some of the real problems it faces. Part II criticizes “reforms” that undoubtedly would make these existing problems worse. Part III examines how government influence has made America’s health care sector what it is, and proposes ways of reducing government influence. We conclude with an outlook for the future, and the role that health savings accounts can play.