NEED TO KNOW

AMERICANS FOR PROSPERITY FOUNDATION

PRICE SIGNALS IN HEALTH CARE

Price signals are incredibly important in a market economy because they provide information about the relative scarcities of resources. Prices tell producers how much to supply, and consumers how much to demand. When the price of a good increases, it indicates that there is either increased consumer demand (which would stimulate higher production), or increased producer costs (which would reduce consumption).

Health care resources, like all other goods are services, are scarce, and fluctuating prices ensure that the doctors, nurses, medications, equipment, and procedures get to the patients who need them most. In health care, as in all other sectors of the economy, when the price of a good increases consumers have an incentive to consume less and producers simultaneously have an incentive to produce more. However, when the government fixes prices, those important price signals are lost. The intervention may result in shortages that would not occur under a free price system, causing distortions in the economy and negatively impact people's lives.

QUICK FACTS

- Price signals help allocate goods and services in a marketplace. Without these price signals producers and consumers alike cannot adjust their behaviors accordingly, resulting in shortages and scarcities.

NOTABLE & QUOTABLE

"[I]f I spend somebody else's money on somebody else, I'm not concerned about how much it is, and I'm not concerned about what I get. And that's government. And that's close to 40% of our national income."

- **Milton Friedman**

HOW GOVERNMENT DISTORTS PRICE SIGNALS IN HEALTH CARE

Prices work in the health care market the same way that they work in any other market. The problem is that when the government intervenes in the health care market too much, these price signals are distorted affecting the quality and availability of services. The government does this by mandating services, fixing prices, and cutting reimbursements to doctors and other providers. This means that health care resources are not allocated efficiently which has harmful effects in the economy and the delivery of health care services.

There are three primary ways that the U.S. government currently distorts price signals in health care: The third-party payer system, low Medicare reimbursements, and government mandates.

THE THIRD-PARTY PAYER SYSTEM

Under a third-party payer system, someone other than the consumer or producer pays the final bill – an insurance company, for example. If the consumer was paying for services directly out of her pocket she would have an incentive to spend her dollars carefully, which would create downward pressure on overall costs as providers worked to deliver the consumer quality services at the best price. But for most transactions in health care, someone other than the patient is responsible for paying the bill, which means that health care consumers lack the incentive to limit their spending.
This leads to over-consumption. A person will consume more health care is he or she doesn't have to pay the full cost of it. That person will see their doctor more often, and have more tests and procedures done, oftentimes much more than necessary – again, with little incentive to control consumption because someone else is paying the bill. This leads to overcrowding in doctors' offices, which means that patients will have to wait longer to get an appointment.

The government is deeply involves as a third-party payer in health care, most notably through its Medicare program for seniors. There are a few incentives for seniors to seek the best value in their health care consumption when the costs are borne by taxpayers as a whole, so it should be no surprise that the cost of the program has continued to skyrocket.

Private health care insurance companies that act as third-party payers undoubtedly face these challenges as well. However, the important difference between the two is that with private insurers, consumers pay a premium for health insurance that fluctuates with the cost of health care and as their own individual health risk rises and falls. Insurance companies must also compete for consumers' business by providing the best health care at the greatest value. Such competition and market-based signals do not exist in Medicare's single-payer system.

LOW REIMBURSEMENTS, FIXED PRICES

Frequently in health care, government will set health care prices through below-market reimbursements to providers like doctors and hospitals. Under Medicare and Medicaid, the government tends to reimburse providers less than the full cost of providing services. This means that the patients demand more services than medical providers are willing to supply, which creates a shortage. Health care providers often refuse to accept Medicare and Medicaid patients because they lose money on the services that they provide, making it difficult at times for the individuals who rely on these programs to find quality health care service.

The government's below-market reimbursement system also raises health care prices for everyone else—those who buy insurance on the private market. In order to stay in business, health care providers have to charge more to regular fee-for-service patients to make up for those patients who pay only the government-mandated price. As a result, prices tend to rise higher than they would in a health care market that is free from such mandates.

MANDATES

Another way that government intervenes is by mandating that insurance companies provide coverage for certain conditions and procedures. Although these mandates are merely intended to promote coverage, they also necessarily raise the cost of health insurance premiums, making it more difficult for individuals and small businesses to afford health insurance plans. It also reduces consumers' ability to choose what they want their insurance to cover and not to cover, since many of these decisions are already made for them by the government.

CONCLUSION

As the government takes on a bigger role in funding health care, the private sector's role will necessarily shrink. This means there will be less competition in the health care market, leading to less innovation and less downward pressure on prices. If the government reduced its role in the health care market and allowed prices to fluctuate, this would improve patient care, reduce medical costs, and allocate health care resources to the patients who need it most. Encouraging market based competition in health care is the only long-term solution that will both increase coverage and lower health care costs.

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