IRET POLICY BULLETIN

March 16, 1994
No. 62

THE CLINTONS' HEALTH CARE REFORM PLAN WOULD INCREASE HEALTH CARE COSTS

Do We Spend Too Much on Health Care?

There are two principal rationales for the Clintons' and similar health care "reform" plans. One rationale is economics: the conviction that the nation spends too much on health care and that health care uses up too much of our production resources. The second rationale has to do with the federal budget: our allegedly excessive outlays for health care are deemed to be a major source of federal budget deficits (President Clinton's budget proposals in February 1993 repeatedly stressed the idea that projected deficits would be materially reduced if his then yet-to-be-specified health plan were adopted).

The budgetary consequences of the existing health care financing system and of the Clintons' proposal have been given a good deal of attention. A number of analyses, most importantly that of the Congressional Budget Office, have concluded that the Clintons' plan would increase the federal budget deficit, notwithstanding the proposed tax increases and reduced spending for Medicare and Medicaid. Much less attention, however, has been given to the equally important question concerning the economic effects of the Clintons' plan, that is, whether it would lead to effectively economizing on the use of resources for health care. [1]

The nation's economic and fiscal health, health care reformers tell us, depends on curbing our appetites for better health. Alice M. Rivlin, deputy director of the Office of Management and Budget, expressed this view colorfully: "Almost everyone agrees that if we are to have the productive, competitive, flexible economy that we all want, we cannot allow the `health care tax' to continue rising. We are already using 14% of our gross domestic product to pay for health care.

[1] See, however, the excellent analyses of the impact of many of the important features of the plan that are provided in the Joint Committee on Taxation Staff Description and Analysis of the Employer Mandate and Related Provisions of the Health Security Act (HR 3600), February 2, 1994.

Institute for Research on the Economics of Taxation

IRET is a non-profit, tax exempt 501(c)3 economic policy research and educational organization devoted to informing the public about policies that will promote economic growth and efficient operation of the market economy.

1730 K Street, N.W., Suite 910 • Washington, D.C. 20006
(202) 463-1400 • Fax (202) 463-6199 • Internet www.iret.org

Every time we let this `tax' drift up another percentage point, we are allocating an additional $50 billion a year of the nation's precious resources to health care." [2]

Ms. Rivlin doesn't make clear why she is so sure that our use of resources for health care is excessive. In itself, the fact that health care accounts for something like 14 percent of the nation's gross domestic product doesn't mean that we spend "too much" on health care or that we use "too much" of our production capability in providing health care services. "Too much" would appropriately characterize our health care spending only if we mean that we are wasting some of the resources we use to provide health care, i.e., the incremental benefit we get from their use is less than their incremental cost. If this is so, it must be because the health care market fails to price health care services accurately.

The prevalent view is that the health care market does indeed produce the wrong price signals, specifically that it *overprices* health care. This view appears to be based on the observation that the prices of health care services are rising faster than the overall consumer price index (CPI).

Comparison of the rate of increase of the prices of health care services with that of the CPI, however, tells us nothing about how effectively the market is pricing these services. If we are indeed using "too much" of our resources for health care, it must be that health care prices, *as perceived by the buyers of health care*, are *too low*; health care must be *underpriced*, i.e., priced below the incremental cost of the services.

If we are indeed using "too much" of our resources for health care, it must be that health care prices, as perceived by the buyers of health care, are too low; health care must be underpriced, i.e., priced below the incremental cost of the services.

Government Programs Distort the Health Care Market

There are, in fact, a number of factors that distort the operations of the health care market, resulting in false price signals. The demand for health care, therefore, is greater than it would be if the prices consumers confront more closely matched the costs of the health care services they buy. The exercise of this inflated demand in response to the artificially depressed prices increases the real costs of health care services. Paradoxically, the government and private practices that reduce health care costs as seen by consumers increase the real costs of providing that care.

[2] Alice M. Rivlin, "Clinton's Conservative Health Plan," The Wall Street Journal, October 20, 1993.

Notable among the factors distorting the pricing of health care are the huge subsidies for the consumption of health services provided by Medicare and Medicaid. For the very large number of people who are covered by these programs, the out-of-pocket cost, even including the Medicare "premiums," of the health care they purchase is only a fraction of the costs of providing that care. For that reason, the amount of health care services that covered individuals buy tends to be substantially greater than if these people had to pay the full costs out of their own pockets. The greater is the amount of those subsidized purchases, the smaller is the incremental benefit obtained from them. At the same time, the greater is the amount of these purchases, the higher is the incremental cost of providing the additional health care. In focusing on the broad issues of health care reforms, policy makers should ask whether the virtues, such as they may be, ascribed to these government programs are adequate to offset the wasteful use of health care services the subsidies entail.

Employer-Provided Health Insurance Hides Health Care Costs from Employees

The present system of privately provided health insurance also tends to result in overuse of health care resources and for essentially the same reason. Much of that insurance is provided by employers as part of their employees' compensation packages. Health insurance, however, is not anywhere near as visible a compensation component as cash wages or salaries, in part because the premiums paid by employers are not included in the employees' incomes for tax purposes, hence do not show up on the employees' pay stubs or on their W-2s.

Indeed, employees tend to think of employer-provided health insurance coverage as a gift from their employers; they often do not realize that the health insurance premiums their employers pay are really a part of their pay package. They overlook the simple economic fact that the more the employer pays for employees' health insurance, the less cash wages, salaries, and other kinds of compensation the employer can and does pay. The result of this unintentional hiding of the cost to employees of employer-provided health insurance is that covered employees perceive health care to be virtually costless and therefore tend to buy more health care than if they were fully conscious of its cost to them — the other compensation they forgo in favor of health insurance. It is, of course, very difficult to make employees really cost conscious as long as they do not have to pay directly for their health insurance out of their after-tax incomes.

Many employers have been made painfully aware of their employees' uneconomical use of health care services by the resulting increase in health insurance premiums. Cutting back or limiting increases in other compensation elements to offset increases in health insurance costs tends to produce serious, costly labor problems. Employers are hesitant about heightening their employees' awareness of insurance costs by eliminating tax-sheltered employer-provided insurance, because this would result in a significant increase in payroll costs; employees would demand increases in cash wages and salaries sufficient to cover not only the cost of the insurance they would want to purchase but also the additional income taxes they would have to pay on the additional cash compensation.

Faced with these difficulties, employers generally have concentrated their cost-saving efforts on limiting the benefits covered by the insurance and by finding less costly health care delivery systems.[3] While these efforts may have slowed the increase in aggregate outlays and the rise in unit costs, they do not eliminate the basic deficiency. The price of health care as perceived by the employee remains less than the cost of providing that care; the uneconomical consumption of health care, though perhaps less severe than it might otherwise be, persists.

Third-Party Payment for Health Care Misrepresents Costs

An additional deficiency in health care pricing results from the third-party payment of the health care bills of insured people, along with the very low deductible and co-payment features of many of the insurance policies. The fact that the insurance company, rather than the individual consuming the service, makes the payment to the doctor, nurse, or hospital providing the service tends to make the consumer unaware of or indifferent to the prices of those services. To be sure, most policies require the insured to pay out of pocket the first X number of dollars of covered services, and the policy premium varies inversely with the amount of X. When the insurance coverage is provided by the employer, the employee may not be acutely aware of the differences in premiums or understand that he or she actually pays the premium. A person who buys the insurance with after-tax dollars is, of course, likely to know the differing costs of policies with differing deductibles, but once the deductible is satisfied, the incentive to buy more health care is unconstrained by the price the person paid for that particular deductible feature of the policy.

The co-payment feature of health insurance policies similarly tends to hide the real cost of health care services from the insured individual. With a 20 percent co-payment feature, for example, the insured person pays only 20 cents for each dollar of health care charge, once the deductible is satisfied. There is little urgency for economizing on the purchase of a service when one need pay only 20 cents for a dollar's worth of it.

By virtue of these influences, the health care market does indeed fail to operate in an optimum way. The market's pricing system fails to reveal the real incremental cost of the volume of health care services that are provided and consumed. As a result, consumers do not adequately economize on the purchase of health care. It is in this sense that too much of the nation's resources are committed to providing that care.

---

[3] For the most part, the less costly delivery systems are thought to be health maintenance organizations (HMOs) and plans that restrict employees' choices of physicians and hospitals to those on a preferred provider list. There appears to be growing dissatisfaction among doctors with these arrangements, along with the conviction that the cost savings really reflect less health care and/or care of lower quality. Michael Tanner cites a 1992 report by A. Foster Higgins Co. to the effect that half the employers switching to HMOs experienced insurance rates as high or higher than those of the non-managed plans they switched from (*The Wall Street Journal*, February 14, 1994, page A18).

The Clintons' Plan Would Further Impair the Health Care Market

The basic question to which the Congress should seek an answer is whether implementing the Clintons' plan would overcome the health care market's failure. Would it result in more accurate pricing of health care services? Would it make people spend more carefully for health care and economize on the use of health care services? Would it, therefore, reduce the amount of productive resources committed to providing health care? Would it reduce total outlays for health care? Would we obtain the same amount of the same quality of health care using a smaller amount of production resources? Would we obtain more and better health care using the same amount of resources?

The basic question to which the Congress should seek an answer is whether implementing the Clintons' plan would overcome the health care market's failure...Unfortunately, each of the major features of the Clintons' plan would further impair the health care market's functioning.

Unfortunately, each of the major features of the Clintons' plan would further impair the health care market's functioning. If the plan were to be implemented, even more of the economy's total resources would be used in providing health care, and the real costs incurred would rise more rapidly and to higher levels than are likely with present trends. This would result in part from the universal coverage provided by the plan and in part from the exacerbated underpricing that other major features of the plan would entail.

Requiring Universal Coverage Would Increase Total Health Care Costs

Universalizing coverage under the Clintons' proposed prepaid health care system must result in greater demand for health care services than would otherwise prevail. Indeed, if this were not so, what would be the purpose of extending coverage to those who are not now insured? Assume, for example, that the 37 million people the Clintons say would be newly covered by adoption of their plan were to consume roughly as much health care as those already insured. Also assume that, on the average, this would be double the amount of care the uninsured now obtain. On the basis of 1990 per capita health care expenditures, aggregate outlays for health care would increase by $55-60 billion, at the outset, and the additional spending would increase as time went on.[4]

[4] Per capita health care expenditures in 1990 were $2,566; with conservative projections of the increase in per capita spending through 1993, the estimated increases in spending resulting from universal coverage would be at least $55 billion beginning in 1994. Health care expenditures are shown in *Economic Report of the President*, January 1993, page 133.

Universal coverage would directly add to the demand for health care. Unless somehow frustrated, e.g., by government rationing, which would reduce the care available to those now insured, the result must be a greater amount of the nation's production resources devoted to delivering health care services and higher unit costs of those services than would be the case if no change in the law were enacted.

Cost Shifting Doesn't Raise Total Health Care Costs

One may wonder why universal coverage is a requirement in the Clintons' plan. Ostensibly, the impetus for this requirement is concern that the uninsured are deprived of the health care services they would purchase if they were insured. Responding to this concern might well call for efforts to identify the reasons why those people were without health insurance and to overcome any serious obstacle to their purchasing it. It is one thing to seek to make health insurance available to everyone; it is quite another to require everyone to have health insurance whether they want it or not. Any such requirement surely is an invasion of the right of people in a free society to determine for themselves how to use their resources in satisfying the wants *they* — not the government — perceive.

The explanation for this feature of the Clintons' plan appears to be the conviction on the part of the plan's authors that the costs of the health care consumed by the uninsured are shifted to the insured in the form of higher fees and charges for health care services and the resulting higher premiums for health insurance. This "cost shifting" is thought to contribute significantly to elevating the prices of health care services, allegedly adding 10 percent to doctors' bills and hospital charges, something like $25 billion annually.[5] These increases in the prices of health care services, moreover, are deemed to be a major factor in driving up federal budget outlays for Medicare, Medicaid, and other government-provided health services. Requiring coverage of those now uninsured allegedly would reduce the billing rates of doctors, hospitals, and other health care service providers, hence reduce total health care costs, as well as Medicare and Medicaid outlays, and federal budget deficits.

Cost shifting attributable to the consumption of health care by the uninsured may raise doctors' fees and hospitals' billing rates, but it doesn't raise the unit or the total cost of health care. The total cost of health care is determined by the amount and character of the health care services that are provided, not by who pays the bills. Cost shifting doesn't itself increase the total amount of production resources devoted to providing health care. On the contrary, cost shifting probably reduces, at least modestly, the total amount of care consumed because the price elasticity of demand for health care is not zero. The higher billing rates and fees charged insured and other paying consumers of health care must reduce the amount of health care services they choose to purchase.

---

[5] The White House Domestic Policy Council, *Health Security: The President's Report to the American People*, October 1993, page 11).

Requiring the nonpaying customers to be insured may curb the increase in billing rates and fees attributable to cost shifting, but it wouldn't reduce the amount of care provided, hence the real unit or total cost of health care. Indeed, it would certainly increase the consumption of care and the real unit costs entailed thereby. In turn, this would exert offsetting upward pressure on doctors' fees and hospitals' billing rates. The net result would almost certainly be substantially higher outlays under Medicare and Medicaid than contemplated in the Clintons' plan, unless price controls and rationing of health care services were imposed.

Moreover, universalizing coverage wouldn't eliminate cost shifting but, instead, would change the distribution of the (greater) cost of health care. A smaller share of the cost would be shifted to those now paying for health care, either out of pocket or through insurance, and more of the shifted cost would be borne by people in their capacities as taxpayers.

The Clintons' Plan Would Accentuate the Underpricing of Health Care

Implementation of the Clintons' plan would exacerbate the distortion of health care prices. The plan would further becloud consumers' perception of the costs of health care and accentuate the underpricing of health care outputs. By mandating employers to provide health "insurance" for all employees and to pay for all but a small fraction of the premiums for that insurance, the plan would disguise the real cost of health care for a substantially larger number of people than at present. By extending coverage to the currently uninsured, the plan would virtually universalize third-party payments henceforth, with the attendant hiding of the real cost of health care services.

As presented by the President, the plan contemplates deductibles and co-payments under the standard policies to be specified by the proposed "purchasing alliances" that are substantially lower than the average of private policies currently provided. [6] Setting these deductibles and co-payments at such low levels would further distort health care consumers' perceptions of the costs of health care, resulting in a greater demand for these seemingly lower-priced health care services.

The plan implicitly recognizes that its implementation would lead to large increases in the demand for health care, hence upward pressures on unit costs. To avert or control these pressures, the plan provides for capping aggregate health care outlays by controlling insurance premiums,

---

[6] "Almost half of today's plans have deductibles larger than $200 per person. Some are as high as $3,000. (Under reform) Many plans will have no deductible; for plans that do, deductibles will be $200 for an individual and $400 for a family... Your co-payments...will vary according to the type of plan you choose. For a wide range of preventitive (sic) services, there will be no co-payment in any plan." For people enrolled in fee-for-service plans under the proposal, the co-payment, after the deductible was satisfied, would be $200 for the individual or $400 for the family and zero when out-of-pocket outlays reached $1,500 for the individual or $3,000 for the family. For people participating in preferred provider organizations, the co-payment would be $10 per visit, if the person chose a participating doctor, and would be the same as the fee-for-service co-payments otherwise. People in health maintenance organization plans would pay no more than $10 per doctor visit and nothing for hospital care once the deductible has been met. The White House, Domestic Policy Council, *op. cit.*, page 31.

hence the amount of spending by the alliances. These alliances would be empowered to reduce doctor and hospital fees to meet the government-imposed spending limits. Some form of rationing of health care, if only in the form of very long waits for service, is an inevitable consequence of this self-contradictory system of reducing the perceived price for health care while attempting to prevent the resulting increase in the demand for health services.

Proponents of the Clintons' plan maintain that the standardization of insurance plans and the resulting reduction in paper work costs under the plan would reduce overall costs as well as the unit cost of health care. There is, however, virtually no chance that reduced paper work or any other economies in the administration of health care resulting from adopting the plan could save any significant part of that amount. Indeed, with the huge increase in the number of federal, state, and local government agencies proposed for the marketing and administration of the insurance plans, paper work and administration costs almost certainly would greatly exceed those under the present arrangements.

...implementing the plan would have an effect precisely contrary to two of its principal objectives...[it] would increase [health care] costs and accelerate their rise, resulting in greater Medicare and Medicaid outlays and budget deficits.

Conclusion

There are substantial reasons for concern about the financing of health care in the United States, reflecting for the most part government and private sector practices that impair the performance of the health care market. Remedying the market's deficiencies calls principally for eliminating those policies and practices that distort health care consumers' perceptions of the prices of health care services. Public policy makers should focus their efforts on removing impediments to efficient functioning of the private market for health insurance and health care, rather than on substituting government fiats for market processes.

The Clintons' plan and similar proposals would eliminate what is left of a free market in health insurance and health care and replace it with an enormously elaborate and complex command and control system. Ironically, implementing the plan would have an effect precisely contrary to two of its principal objectives; instead of reducing health care costs and curbing their increase, the plan would increase those costs and accelerate their rise, resulting in greater Medicare and Medicaid outlays and budget deficits. To avert these consequences, price controls and rationing would be required, outcomes that are recognized in many of the plan's provisions. The ultimate costs of the plan would be found in poorer quality of health care for most Americans and the loss of freedom in one of the nation's most important markets.

The Clintons' plan is the wrong framework for addressing the impediments to efficient functioning of the health care market. Instead of discarding market processes, the Congress should look to those elements of public and private policies that distort health care consumers' perception of the cost of health care. The remedies that would emerge from this focus on health care issues would ensure a healthier America.

Norman B. Ture
President