Lecture 4: The economic perspective: nature, roles and limitations

- Main objectives of this lecture
- Why do we study economics in a health policy course?
- The basic model of economic analysis – the 'perfect market'
- Imperfect markets
- Limitations of the perspective when applied to health care
- Is orthodox economics pro-market?

Main objectives

- To enable you to identify key economic terms so that you do not employ them uncritically
- To show you that economics is a perspective that like all perspectives has limitations
- To suggest which of these limitations are particularly significant for health care policy

Why study economics?
Some examples of economic terms used in health policy: World Bank's economic rationale for a governmental role in health care

- "The poor cannot always afford health care that would improve their productivity and wellbeing. Publicly financed investment in the health of the poor can reduce poverty or alleviate its consequences.
- Some actions that promote health are pure public goods or create large positive externalities. Private markets would not produce them at all or would produce too little. […]
- Market failures in health care and health insurance mean that government intervention can raise welfare by improving how those markets function." (WDR 1993, 52-3)

Justifying out of pocket payments in the Netherlands

Health Insurance Act (Zvw)

"For basic health insurance, a compulsory deductible of **€**155 (2009) is levied for all individuals aged 18 or older. […]

"The deductible should make citizens more aware of the costs of health care in order to prevent undesired moral hazard, that is, the use or provision of more or more expensive medical services caused by the fact that expenditures are (partly) compensated by insurance."

(Schäfer et al. Health Systems in Transition. Vol. 12 No. 1 2010)

Competition saves lives

The Telegraph

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300 heart attack patients saved a year under competitive NHS

The lives of 300 heart attack patients have been saved every year since competition was introduced to NHS hospitals, according to a new study.

By Martin Beckford, Health Correspondent
6:45AM BST 28 Jul 2011

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Research published in an academic journal said that the number of deaths avoided across the whole health service is likely to be "significantly higher" since patients were given more choice and managers more freedom.

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The intellectual appeal of markets is based on two highly influential claims made by economists

MARKET COMPETITION MAKES PRODUCERS MORE EFFICIENT

For example, Roberts et al (2004, pp225-35) write:

"Competition is desirable because it pushes sellers to keep down costs and prices and respond to customers in order to attract additional business."

In other words, competition tends to eliminate the slack, lazy, arrogant or inefficient firm.

MARKETS DISTRIBUTE RESOURCES ACROSS SOCIETY IN THE BEST POSSIBLE (MOST 'OPTIMAL') WAY

For example, Crouch (2011, 17) writes: "'Optimal outcomes will be achieved if the demand and supply for goods and services are allowed to adjust to each other through the price mechanism, without interference by government…"

In other words, the price system values what we want as individuals; prices reveal what consumers want in the marketplace; and if the price system works correctly, resources are channelled to what we most want.

Therefore, the price system is the best means of allocating resources in society.

Economic analysis is based on a set of "perfect market" assumptions

- A large number of sellers in the market (the individual firm is a price taker not a price setter or monopolist)
- Freedom of entry into and exit from the market (no barriers to entry exit; inefficient firms that cannot make a profit at the prevailing market price leave)
- Product homogeneity (there is no differentiation between products sold by different suppliers)
- Perfect knowledge (all buyers and sellers in the market have complete knowledge of the conditions in the market)

ECONOMISTS SAY THAT GIVEN THESE CONDITIONS MARKETS WILL PRODUCE A SOCIALLY OPTIMAL ALLOCATION OF RESOURCES

The perfect market model underpins key economic concepts

- Allocative efficiency
  - The optimal outcome for society measured in terms of total 'utility' or 'welfare'

- Utility or welfare
  - That which is maximised in an allocatively efficient state of affairs - preference or want satisfaction. (Utility is a basic unit of analysis but, rather surprisingly, it is not unambiguously defined)

- Productive or technical efficiency
  - A precondition of allocative efficiency that measures how effectively inputs to the productive process are used. Thus welfare can be increased by improving the efficiency of the productive process without increasing inputs. The claim that market reforms improve cost efficiency is a reference to this type of efficeincy.

Economists accept that markets do not always lead to socially optimal results: this is what economists mean by 'market failure'

- Monopoly
- where a single producer can determine market price

- Information asymmetry
- Knowledge not perfect

- Externalities
- when prices fail to incorporate all costs and benefits

- Public goods
- non-excludable and non-rivalrous goods (opposite of commodities or economic goods)

Debates within economics

- If all markets are imperfect, can economists predict what happens in imperfect markets?
- Where market failures are concerned, economists may argue that the market should be improved (for example, by increasing information or by breaking up monopolies using anti-trust or pro-competition law)
- Or they may reject market pricing and accept that governments should put a price on externalities like environmental damage
- Or they may accept that the government has to intervene and provide ‘public goods’ but disagree about what these are
- Some schools of economics accept monopolies

Problems with applying this supply and demand framework to health care (as set out by Kenneth Arrow, the founding father of health economics)

Demand

- In many systems, those who pay for care are not the same as those who consume it
- In health care, the concept of need may be more important than the concept of demand
- Consumers can't know everything about alternative health care providers or treatments- there can't be consumer sovereignty (information asymmetry)
- Efficiency can't be measured in terms of traditional 'utility' of welfare

Supply

- Claims about cost efficiency are meaningless without measures of quality
- Quality is hard to define and quality measures may not be agreed
- Economics does not deal with equitable distribution of health care or the structures needed to ensure it
- Producers can't know everything about the health risks associated with each patient (information asymmetry)

It is often argued that economic analysis can promote market over government control

- *Utility maximisation*

Inconsistent with citizens' rights and promotes view of health care as a commodity (an economic good that is bought and sold in a market)

- *Consumer sovereignty*

A principle used to question the role of government

- *Welfarism*

The principle that the output of the health care system is (a) known and agreed, and (b) not equity

Conclusion

You should not use economic terms uncritically or unquestioningly.

You need to be alert to the extent to which an economic perspective or definition of the problem promotes market over non-market solutions