The Role of Government in Health Care

**Question 1:** What are externalities?

**Answer 1:**

*Externalities* are another manifestation of market failure. Externalities are secondary effects. These effects may be favorable or unfavorable. In other words, externality has occurred when someone makes a decision, but others must pay (or they receive benefits). For example, suppose that the local health unit in a community charges for flu inoculations. The people who actually go to the unit to receive the shot will pay the cost, but the entire community may reap benefits. The fewer flu victims there are, the lower the chances are for other members of the community to get sick. Also, the major employers in the community will benefit. The workers have paid for the inoculation, but the businesses benefit from a healthier workforce. One rarely considers externalities when making consumer decisions. The result of externalities is that some will receive a benefit at no cost when they would otherwise be willing to pay for it.

There are two effects of externalities. One concerns economic efficiency; all benefits do not equal all costs. The second effect is one of redistribution. Some people will receive a benefit and not pay anything to the provider. The other side of this is that some may have to pay a cost and receive no benefit at all.

It is easy to see in the previous example that it may become very difficult to collect from all the individuals who benefit from the flu shots. This is because (among other things) there are large numbers of beneficiaries involved and a very limited amount of man power to devote to the task of collection.

**Question 2:** What are the externalities in health care?

**Answer 2:**

One group of externalities related to medical care can be labeled *consumer protection*. It is easy to understand that the American public can certainly benefit when minimum standards are established in society for those individuals who are interested in becoming health care professionals.
The Role of Government in Health Care

There are also externalities in consumption. In the United States, it is pleasing that even those citizens who live in poverty have access to at least a minimum level of health services. In this case, someone else must subsidize the services. Theoretically, everyone receives the benefits from this though not everyone pays.

It would be difficult to ensure that everyone who benefits from a health care program will be certain to pay. The overwhelming amount of staff time to accomplish this feat makes this impossible to attempt.

**Question 3:** What are the implications of externalities in health care?

**Answer 3:**

The Federal Government is, in theory, acting as the agent for society’s members who feel a humanitarian need to help those who need health care but who live in poverty. Government can tax the wealthy and use these funds to help the poor in this regard.

To whose desires should the government be most responsive? Should it be the desires of those who contribute the funds or those who will receive this benefit? The government should represent the desires of the donors. These donors may be willing to contribute only if the money goes to a particular benefit and particular group. The lower the recipient group’s income is, the more the donor will be willing to give.

The recipients will always want cash income instead. This debate will continue about the level and the form of governmental support in this area.

**Question 4:** What is the role of government when externalities occur?

**Answer 4:**

The Federal Government does have legitimate roles in situations where externalities occur in the health care market. It is in a unique situation to investigate the magnitude of the benefits and of the costs. Although (as you
The Role of Government in Health Care

may imagine) this can be difficult and very subjective. One quantitative tool used time and again by government investigators is cost-benefit analysis (CBA). This analysis seeks to help define the best level of output when these externalities are present.

Another viable role of the government in these matters is to decide how the activities that produce the externalities will be financed. In other words, the government decides who will benefit and who will pay through tax dollars.

A nonhealth care example of this principle would be building an aircraft carrier. When the government takes on such a project, it is (in many respects) very different than a private individual doing it. There are certainly many individuals who do not pay tax who will ultimately benefit from the perceived protection of the carrier. An individual building such a carrier (involving hundreds of millions of dollars) would have a difficult time financing and paying for it. The Federal Government can finance it through tax and/or bonds. No one will threaten the note due and repossess the aircraft carrier.

Question 5: What are the reasons for government interventions in health care?

Answer 5:

The intervention of government into the health care industry is historical and increasing. Government’s activities in the market are certainly not limited to matters of medical care; it occurs in several market segments. Usually this intervention is brought on by two perceived situations: market imperfections and market failure.

When one takes a long look at the health care market, one may see several imperfections. Consumers do not have perfect information; they must rely on the opinions of others. Another imperfection is that providers do not (in a great many instances) have the incentive to minimize the costs of treatment.

Market failure occurs when the market diverges from the competitive state. In the health care industry, this divergence may be bolstered by the fact that
The Role of Government in Health Care

there are many compelling barriers to entry into the market. In one sense, the government may nurture entry into the health care industry, but the totality of government activity is certainly creating hindrances to entry. Examples are the licensing and regulating of the medical professions and facilities. On one hand, the government causes (or accentuates) market failure. On the other hand, it intervenes because of that failure.

**Question 6:** What should the Federal Government do to control the costs of health care?

**Answer 6:**

The continuing escalation of medical costs in the United States has kept this topic at the top of the federal political agenda. To this point, no national policy has seemed to control the cost spiral. It is U.S. traditions that have lead to health cost escalations. Just because the United States is a rich nation, its citizens do not have to spend so much on health care.

Some of the actions that the Federal Government may consider in this regard include the following:

- **Controlling capital costs:** One reason that costs are so high is the competition between health care organizations. Each must have the very latest in technology to remain competitive. In European countries, the federal governments own health care technology and place it strategically.

- **Negotiating hospital per diem charges:** Diagnosis-related groups (DRGs) have not seemed to work in the United States; their record is very spotty. The Federal Government should consider what has worked in Canada because it has wrestled with many of the same problems. The Canadian government has negotiated not-to-exceed fee limits with hospitals.

- **Negotiating physician fees:** There will always be an automatic constituency against cost control in the United States. The continuing
spiral of health care costs represents a continuing transfer of wealth from the rest of society to doctors.

**Question 7:** What future government initiatives in health care are probable?

**Answer 7:**

Many times the Federal Government will look to the states to see what works and then will consider using it on the federal level. Presently, the Government Accountability Office is studying the outcomes of a program in Oregon’s Medicaid program for possible use in the federal Medicare program. Some have called Oregon's plan *health care rationing*. The centerpiece of Oregon’s program is a list of 709 medical conditions each paired with a specific therapy. Each of these pairs are ranked and given a numerical value that weighs costs effectiveness.

Every two years, Oregon’s politicians build a budget to decide what percentage will go to health care. If the state budget shrinks, so does the list of services. Legislators draw a line through the list where the budget allocations end. The procedures above the line are covered; those below the line are not covered.

Despite many studies that conclude that managed care plans have a negative impact on the quality of health care for some groups, the Federal Government is encouraging the states to enroll recipients in managed care programs.

**Question 8:** What is the goal of consumer protection?

**Answer 8:**

The United States has seen the magnitude of some of the horrendous effects of the market when it functions without any government intervention at all. Few people will advocate for total laissez-faire attitudes from government regulators. In that respect, there are legitimate roles for the Federal Government to play in the marketplace. One of these roles concerns
The Role of Government in Health Care

consumer protection. These governmental efforts have generally been in the areas of restrictions regarding entry, information, and price competition.

The government has closely regulated the process for entry into medical practice because of the serious, potential threat of harm from incompetent medical treatment. In addition, the government has historically restricted information regarding prices and quality. In the near past, this situation has somewhat changed because of antitrust activity.

Feldstein (2005) advises that "when faced with imperfections in the marketplace, the appropriate role of government should be to eliminate restrictive practices and directly address the need that the restrictions were ostensibly imposed to meet" (p. 422).

Reference


Question 9: What is a natural monopoly in healthcare?

Answer 9:

The market may not produce the optimal amount of output. Feldstein (2005) explains that a natural monopoly is one of these instances. When many companies are competing in a market, one strategy is to increase the scale of production so that the relative costs of services are lower. This will certainly give one of the competitors an advantage. A natural monopoly will occur, and others will have to leave the market. When this happens, the remaining monopoly can increase the costs of the service to the point that price will exceed marginal cost. Marginal cost is "the change in total costs from producing one additional unit" (Feldstein, p. 518).

This situation is rare in the health care industry. Natural monopoly has not been a valid argument for government intervention. It is doubtful that regulation can improve a health care company’s overall performance.
As long as entry into the health care market is (at least theoretically) possible, and antitrust initiatives are actively pursued by the Federal Government, competition can indeed exist.

**Reference**


**Question 10:** What is cost-benefit analysis (CBA)?

**Answer 10:**

Historically, the Federal Government has embraced and utilized the quantitative tool of cost-benefit analysis (CBA) in its efforts to determine the optimal level of output where externalities have occurred in the health care market. CBA is a scientific tool used to assist decision makers in comparing costs to benefits over a long period of time. It can be used in two ways: to compare several alternatives or to help decide if a lone, discrete project should be undertaken.

CBA is a limited tool because assumptions must be made in its use and because decisions are made in a political arena where rational approaches are not always the best choice. Assumptions must be made about what the value of money will be many years into the future. This can be very difficult to predict.

There are rules of CBA that should be followed. When deciding if a single project should be undertaken, the rule is this: The *present value* must be greater than zero. Basically, the benefits must be greater than the costs. When choosing between feasible project alternatives, one should select the alternative with the greatest present value. One should choose the alternative that will produce the most net benefits.