

## The Health Care Death Spiral

Submitted to Denver Post, 3/11/03 (but not published):

Linda Gorman's 1/12/03 column, "Road to Medical Hell", opposes a single payer system and offers a free market-based system as a solution to the failure of our health care system. And on 2/25/03 Republican Senator Bill Thomas (CA) was heard on NPR's Morning Edition saying, "I always wondered why the Democrats thought that the average American was smart enough to handle auto insurance, they were smart enough to handle home insurance, but somehow when it came to health insurance it was just far too confusing for them to handle."

Republicans and Libertarians seem unable to understand that it's not a matter of "smart enough." Health care is fundamentally different. Unfortunately, free-market ideologues have a partial and distorted view of reality: they focus on the individual, without taking into account the whole.

Here are the reasons why our current, fundamentally free-market-based, system is failing.

**Adverse selection:** Healthier people tend to take the risk that they can do without insurance, leaving the less healthy in the system. Premiums rise and again the most healthy, as well as many who just can't afford it, drop out. The rising premiums and increasing dropouts of the healthiest is a reinforcing feedback death spiral.

This adverse selection effect causes havoc in a market economy due to asymmetric information, in this case because insurance buyers know their health situation better than insurance sellers. The understanding of this phenomenon is so important that those who developed it were awarded the Nobel Prize in 2001.

Unfortunately an awareness of its impacts has not sufficiently worked its way into the political realm. It explains why a Republican-proposed insurance-based prescription drug proposal would fail. People who know they don't have as much need for prescription drugs will drop out ... and the death spiral begins.

Though adverse selection is the fundamental driver of system failure, two other effects accelerate it.

**Dropouts get sick:** Some of the most healthy take a risk, betting they won't get sick, and don't get insured. Others simply can't afford it. Some of these people lose the gamble and get sick. The logical outcome in a pure free market system would be to just let them sicken and die. Thankfully, for the most part, our society is unwilling to do that. They often get some kind of government-funded care. The costs, including excessive emergency room bills, are passed on to the public in higher taxes, and to businesses in higher premiums, as much as 15 percent higher.\* The higher taxes and higher premiums to businesses cause even more people to drop, or be dropped from, coverage, reinforcing the death spiral.

**Loss of positive externalities:** We don't take advantage of them. For example, when you spend money on your health care, it benefits me. First, when you're not sick, I'm less likely to get sick, and, second, because if we work together, I'm going to be more efficient when you're in good health. Therefore, the result is higher premiums and less income to pay them when everyone isn't covered.

**Short-term orientation:** Even though it's a lot more efficient to prevent health problems than it is to treat them once people get sick, all companies, including HMOs, find it difficult to spend now for lower costs in the future. It's much faster and easier to deny care, to save now by not spending on prevention. People denied care often sue, which drives up costs. And, according to a 1999 Institute of Medicine report, "To err is human," two studies show that between 44,000 and 98,000 hospitalized Americans die each year due to medical mistakes. This costs lives and also results in lawsuits. So instead of driving costs down by prevention and providing adequate care, our system now drives them up due to the higher costs of treating people after they get sick and legal expenses.

Unfortunately, Mr. Bush's solution is to cover up the root causes of the legal problems by taking the determination of lawsuit awards away from juries, who hear all the evidence, and impose one-size-fits-all caps on awards. Somehow he sees frivolous lawsuits as the problem, but doesn't see frivolous

appeals as a problem.

In summary, adverse selection, costs being passed on to the public in taxes and to businesses in higher premiums, not taking advantage of positive externalities of health care, a lack of emphasis on prevention, denying coverage, and inadequate prevention of medical mistakes are causing the death spiral of our health care system.

The market is a powerful mechanism and it works well for most products and services. But there are problems for which only collective, government-based solutions will suffice and for which individualistic, market-based solutions are doomed to fail. Health care is just one example. Market solutions also fail for fisheries, farming, power production, and commons preservation (maintaining clean air and water).

Our society values radical individualism. Our greatest fear seems to be the collective. For example, the ultimate enemy in much science fiction is of a collective nature. The Borg of "Star Trek" is the best example; the loss of individual identity is the equivalent of death.

\*Study: 'hidden tax' funds Medicaid. Businesses pay higher premiums 11/16/01 (article included below)  
<http://www.denverpost.com/Stories/0,1002,33%257E227019,00.htm>

Below are several related articles/columns that illustrate some of the points I make in the paper on health care. They came out after I'd written the original version of the paper. Health Care: A Systems Perspective.

<http://www.nytimes.com/2001/10/14/opinion/14KRUG.html>  
**October 14, 2001 RECKONINGS**  
**Harvest of Lemons By PAUL KRUGMAN**

What does a Princeton degree have in common with a peacock's tail? Both are ornaments that demonstrate their possessor's quality. And the winners of this year's Nobel Memorial Prize in Economic Science showed, among other things, why it may be worth acquiring such ornaments, even at considerable cost.

One of the downsides of this column is how often I must argue against really bad ideas. So it's a nice change of pace, especially in these fraught times, to write about the really good ideas of this year's laureates. Recalling the wonderful papers of George Akerlof, A. Michael Spence and Joseph Stiglitz reminds me why I became an economist in the first place.

All three men focused on the complications a market economy faces when information is "asymmetric" — that is, when sellers know something buyers do not, or vice versa.

Mr. Akerlof started the field with his classic paper "The Market for Lemons." He pointed out that sellers of used

Similarly, our society fears collective solutions; they smack of communism. But unless we want to stand by and watch many of our social and economic systems continue to collapse around us, we'd better get over it. We must shun ideological extremes and design practical systems.

Juveniles, libertarians and economic conservatives neglect responsibilities to the whole, adopting a teenage, foot-stomping "I want to do what I want to do" attitude. But maturity requires balancing between the extremes, just as in a family we must balance individual needs and family needs.

The libertarian view of reality, of "how the world works," is as partial and distorted as the communist view. Both see only part of the truth and both are fatally flawed. There's a word for those who are out of touch with reality; we call them insane ... and we don't let them make public policy.

Bob Powell  
Colorado Springs

My first draft ended: "There's a word for those who are out of touch with reality; we call them insane ... and we lock them up."

cars — and many other items — are often better informed than potential buyers about the quality of those items. This means that the selection of goods actually made available is biased toward low quality: the owner of a trouble-free car is less likely to sell than the owner of a lemon. This in turn means that the buyers of used cars demand a substantial discount, which further discourages owners of good cars from reselling them. Rational buyer suspicion therefore prevents deals that would have benefited both buyers and sellers: the invisible hand drops the ball.

So what's the answer? Loosely speaking, Mr. Stiglitz looked at how those with information can be persuaded to reveal it. For example, insurance companies use deductibles to screen clients: those who know themselves to be good risks are willing to accept policies with larger deductibles. But this screening comes at a cost: in order to get a good rate, an insurance buyer must accept incomplete protection.

Mr. Spence looked instead at how those with inside information can credibly convey it. For example, a student who

knows himself to be smart and motivated can signal those qualities to potential employers by graduating summa cum laude at an elite school; the demonstration of his quality may be more important than what, if anything, he learned. (In "Liar's Poker," Michael Lewis offered a meaner but similar analysis: he declared that would-be investment bankers studied economics in order to demonstrate their willingness to engage in boring, humiliating activities.)

About those peacocks: evolutionary theorists believe that one of the main reasons for extravagant displays like the peacock's tail is that they demonstrate a male's fitness to skeptical females. The tail is, of course, a handicap in other matters; that's why it's a credible signal. Biologists spent years arguing bitterly about whether the "handicap theory," introduced in the mid-1970's, made sense; they could have saved themselves considerable effort if they had realized that their theory was identical to the theory of "market signaling" Mr. Spence had introduced to economics some years earlier. This is all fun stuff, but does it have any policy relevance? You bet it does. To take only one example, asymmetric information is a key reason why it's important to police insider trading: potential stock investors will stay on the sidelines if they suspect that low prices, instead of representing buying opportunities,

<http://www.denverpost.com/Stories/0,1002,33%257E227019,00.html>

**Study: 'hidden tax' funds Medicaid. Businesses pay higher premiums**  
**By Marsha Austin Denver Post Business Writer**

Friday, November 16, 2001 - Colorado businesses pay thousands of dollars annually in what amounts to a hidden tax to cover the cost of medical care for low-income and uninsured residents, according to a Denver Chamber of Commerce study published Thursday.

The so-called hidden tax comes from offsetting the expense of providing medical care to Medicaid beneficiaries and indigent patients. It is borne by doctors, hospitals and health plans that wind up charging those with private insurance more, the chamber's report found.

A Medicaid program that pays doctors and hospitals only about three-quarters of the cost of caring for its members and an estimated 710,000 Coloradans who have no health insurance are a major cause of the double-digit premium increases that employers face next year, according to the study.

Health experts don't know exactly how much of next year's premium increases can be attributed to the cost-shifting, but it could be as high as 15 percent, said Bill Lindsay, a health benefits consultant at Denver-based Benefit Management and Design.

In 2001, the average HMO premium cost \$200 per month, per single employee. Employers picked up an average \$168 of that amount, according to the Kaiser Family Foundation.

For a 100-employee business facing a 20 percent increase in health benefits costs for next year, that means an additional \$6,000 will go to pay for medical care for members of government health plans and those who can't pay.

usually reflect bad news they haven't heard about.

Or to take a more pointed example: the theory of asymmetric information tells us why the Bush administration's plan for prescription drug coverage under Medicare — remember that? — wouldn't have worked. That plan was based on the claim that coverage could be provided on the cheap by subsidizing insurance companies. But people are likely to know more than the insurance companies that cover them about their future drug costs; this puts retirees seeking drug insurance in the same position as people trying to sell used cars. Insurance companies would set rates high, denying coverage to most people, out of the rational suspicion that their clients would consist disproportionately of "lemons" — people with high drug expenses.

Of course, I don't expect politicians and lobbyists to understand such arguments; as Upton Sinclair said, it's difficult to get a man to understand something when his salary depends on his not understanding it. But there will be plenty of occasions for cynicism in future columns; for now, let me simply celebrate an inspiring economics Nobel.

If half of that business's employees chose to insure a spouse and two children, that number would jump to more than \$12,000 for the year.

And that's just the employer's contribution. Employees would also face similar increases.

Business leaders advised state health officials to manage the current level of funding more wisely.

Some chamber members were shocked when Don Hall, chief executive of Colorado Access - a Medicaid HMO - told them that 1 percent of Colorado's approximately 250,000 Medicaid members account for 60 percent of the program's cost.

"I'd be all over that 1 percent," said one chamber member, referring to what would happen if such an inefficiency showed up in a private company.

To solve the problem, business leaders want the state to overhaul its Medicaid programs. They want budget constraints on the state program lifted; they seek to make it easier for the working poor to qualify; they hope to get more members into HMOs; and want the government to subsidize private health insurance premiums for low-income workers who can't afford employer-offered benefits.

Colorado is among the states that make it toughest for residents to qualify for Medicaid. Only 5.9 percent of the state's population is covered by Medicaid, compared with 12.2 percent nationally.

The Chamber of Commerce says Colorado has inadequately funded its Medicaid and indigent care programs

and that businesses are paying. In its report, the chamber suggested that costs now borne indirectly by private industry - the hidden tax - could be better controlled if consumers and businesses simply funded the program with direct taxes.

At the same time, business leaders know one huge hurdle to accomplishing this are state laws that limit government spending to about 6 percent a year.

There's no question with a declining economy that the pressure will be even greater to lift the spending cap for state health programs, said Ed Kahn, an attorney and representative of the Colorado Consumer Health Initiative.

But it could be tough to find political support for wide-sweeping health care reforms with Colorado facing a \$400 million budget shortfall and legislators scrambling to find money for schools, roads and other taxpayer-supported programs, said Larry Wall, president of the Colorado Health and Hospital Association.

At a meeting Thursday where the chamber's study was released, business owners also discussed with private and public health officials other innovative state programs that have successfully expanded health services to low-income residents without substantially increasing cost.

<http://www.denverpost.com/Stories/0,1002,417%257E228481,00.html>

#### **Denver Post editorial: Band-Aid for ER crisis**

Saturday, November 17, 2001 - A crisis infects metro Denver's emergency medical system, a key symptom being how ambulances often must search for any hospital willing to take new cases.

That's because existing rules let hospitals tell ambulances they can't come to their doorsteps, forcing the vehicles to "divert" to another emergency room.

Frankly, many observers think Denver area hospitals put themselves "on divert" too readily, using the status not as a legitimate warning they're already overbooked but as a slick tool for refusing uninsured or difficult cases.

This week, the Colorado Board of Health took steps to relieve the crisis - but the move was akin to slapping a Band-Aid on a hemorrhage. More must be done by the health board, the legislature and federal officials.

Metro hospitals now tell ambulances to go elsewhere if any of nine wards is full. The loophole lets ERs decline patients too easily and puts too much responsibility on ambulance crews. So, the health board considered new limiting when hospitals may "go on divert."

But hospitals balked at the new mandate, so the board offered a compromise: Hospitals themselves would limit the reasons they can claim "divert" status. Under the hospital association's plan - which is tougher than the state's proposed rules - divert status can be claimed only if the

Other states have taken creative approaches to provide health coverage to low-income residents. Here are some examples included in the chamber's report:

In Arizona, all Medicaid members are enrolled in HMO plans that limit the kinds of drugs they pay for, which encourages the use of generics. Doctors and hospitals compete to be the providers of choice for the state plan, urging participation and lowering cost.

Arizona also pays nursing homes under a capitated system, which means the home gets a predetermined amount of money to care for Medicaid patients. If costs are higher, the nursing home absorbs them; if costs are lower, the nursing home makes money.

In Oregon, the state compiles a list of all medical services for Medicaid members in order of priority. The most necessary care is at the top, and procedures and care the state finds expensive and less medically necessary are at the bottom. The state starts paying for care at the top of the list until its funds dry up.

Florida's Medicaid dollars subsidize private health insurance premiums for low-income workers who wouldn't normally qualify for Medicaid but can't afford private insurance on their own.

hospital already has two patients awaiting intensive care, if all ER staffers are caring for other patients or if the hospital has lost water and power. State health department employees will report monthly to the health board on how well hospitals adhere to the new guidelines.

But the new system lacks an effective enforcement mechanism. If the voluntary plan doesn't work, the health board should implement new mandates with penalties for non-compliance.

The plan follows other efforts to clear up the ER tangle. This summer, hospitals and ambulances were linked to a computer network that tells ambulance crews which hospitals are on divert so they don't have to make radio call after radio call for information.

However, these steps don't fix the underlying problems: a nursing shortage, a lack of beds for emergency cases and a federal law that says only ERs may see uninsured patients (which bizarrely means medically indigent patients can get care only at the health care system's most expensive portal.)

The ER crisis generally escapes the public's daily notice. But if left unresolved it could someday mean that you or your loved ones may find themselves traveling unduly long distances for an ER that's still taking patients.