Health Matters . . . a continuing forum

How the Healthcare Market Differs from Other Markets

by Rajiv Sharma and Renu Gehring

Healthcare constitutes an increasingly large portion of the economy. At the beginning of the 20th century, expenditure on healthcare comprised about 2 percent of US spending. By 1960, its share of spending had increased to 5 percent. Healthcare today accounts for nearly one sixth of both Oregon and US economies.

Spending on healthcare is likely to continue to grow in the foreseeable future for several reasons. Medical techniques continue to become more sophisticated increasing the need for expensive equipment, supplies, medicines, and highly-trained workers. The healthcare system also faces a rapidly ageing population of demanding healthcare consumers. Finally, chronic conditions, especially those associated with obesity, are on the rise. In this article, we examine why healthcare is different from other goods and services. We also address several key questions related to healthcare expenditures from an economic perspective.

Why is healthcare different from other industries?

Our understanding of how the economics of health and healthcare differs from that of other industries owes much to Victor Fuchs and his colleague Nobel laureate Kenneth Arrow. Most distinctions we identify here can be traced back to their work.

Unlike most of our other purchases, pleasure of use rarely inspires us to consume healthcare. Healthcare saves lives and improves health. While we can estimate and—with foresight—plan for most other expenses, variability in healthcare expenditures is much higher than for other major categories of spending.

Most of us require no more than $2000 worth of healthcare in a given year. However, a small number of people face catastrophic expenses. One percent of individuals utilize an annual average of over $150,000, and account for about 30 percent of all healthcare spending. Public programs and private insurance help to protect consumers from such catastrophic expenses.

Another distinguishing feature of healthcare is the inability of consumers to determine what services are appropriate for them. Patients rely on the expertise of physicians and other providers to make decisions on their behalf. This obstacle and the fact that so few alternatives are available to patients make consumer choice a less than effective means of improving quality in health care. The lack of information available on pricing of care also makes it very to difficult to comparison shop. *(A subject featured in other articles of this issue of* Oregon's Future—*Ed)*

Why is healthcare expensive?

A fundamental reason why healthcare is expensive is that people are willing to pay large amounts of money to avoid pain, suffering, and death. A Lasker Foundation-OHSU report on the value of improvements in life and health (prepared by Sharma and colleagues) found that, in current dollars, reduced mortality from heart disease alone was worth over $13 billion annually to Oregonians between 1970 and 1990. Economists project value on years of life saved by analyzing what people pay for gains in longevity when they choose safer jobs and buy safer cars. Oregon's total spending on healthcare was about $8 billion in 1990. Comparing what Oregonians actually spent on healthcare to what the Lasker Report projected they were willing to spend suggests that Oregonians got a good deal for their money. The same report concluded that the value of

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potential future improvements in health and longevity is also enormous. This high value we put on life and health tends to encourage higher rather than lower prices.

Several factors relevant to the production of healthcare also contribute to making it expensive. Sophisticated medical technology requires expensive equipment, supplies, medicines, and a

highly-trained workforce. A significant factor in rising healthcare costs is that current incentives offer few rewards for decreasing costs, and technological innovation remains biased toward advances that raise rather than lower the amount of money spent on treatment of disease.

Many countries, such as Canada and Britain, control costs by setting fixed national or provincial budgets for healthcare. These healthcare systems effectively receive a finite pot of money. In Canada, this amount is 10 percent of national spending, while in Britain it is 8 percent of national spending. Fixed budgets result in limits and waiting lists for some types of procedures. The healthcare system in the United States is more decentralized with few limits on types or numbers of procedures. As a result, many interventions and procedures take place in the US that would not be paid for by the health systems in other developed countries. For example, US patients undergo advanced imaging far more often than Canadians — the Pittsburgh metropolitan area in Pennsylvania has more MRI machines than all of Canada.

Increasing expenditures and disaffection with the healthcare system are not unique to America. Both Canada and Britain have recently seen large increases in budgetary allocations to healthcare. Between 1988 and 2002, the proportion of Canadians who believe that their healthcare system worked well dropped from roughly 60 percent to 20 percent. *(Please see Mark Kaplan's article "Myths and Realities of Canadian Medicare" —Ed.)*

How much can we afford to spend on healthcare?

To put health spending in perspective, it is important to note that expenditures in several other sectors of our economy also account for large proportions of the economy. Housing and transportation accounted for 27 percent and 16 percent of US consumers' pre-tax income in 2002. A few industries, such as information technology and wireless communications, have seen their share of the economy expand at a faster rate than healthcare in recent decades. While individuals and families regularly grapple with questions of affordability in spending on all kinds goods and services, the question of what we as a society can afford to spend is posed by policy makers much more frequently for healthcare than for other industries.

One key reason why consumers, policy makers, and analysts question the affordability of healthcare more frequently is that most of it is not paid for directly by those receiving the care. The dollars we pay out-of-pocket for healthcare have declined from 81 percent of spending in 1929 to 15 percent in 2002. Federal and state governments now pay for nearly 45 percent of all US healthcare expenditure. Employment-based plans and other types of private insurance pay for another 35 percent.

These third-party payers—so called because they are neither providers nor recipients of treatment—serve a useful purpose by providing protection from potentially ruinous medical bills. However, they also sever the link between use of healthcare resources and payment. Thus, people who use few healthcare services continue to see increases in both in their premiums and the number of their tax dollars devoted to healthcare.

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A second reason is the difficulty that consumers face in evaluating the healthcare they receive. When individuals and families spend money on houses, cars, computers or cell phones, they see the tangible benefit of the additional spending. People also easily evaluate tradeoffs between, for example, an expensive house near their place of work compared to a cheaper house with a longer commute. In healthcare, it is difficult for a patient to determine whether an alternative, possibly less resource-intensive treatment, would serve the same need, or have similar value.

Additional resources devoted to healthcare may provide valuable improvements in life expectancy and health that exceed the value of goods and services from other sectors of the economy. In that case, increases in healthcare spending will be justified. However, if the healthcare system is inefficient, then even relatively low levels of expenditure will entail billions of wasted dollars. A key task for health policy-makers, physicians, and other players in healthcare, therefore, must be to improve the value obtained from the resources devoted to healthcare.

How can we improve the value we get from health spending?

In most industries, improvements in the value products yield arise from efforts of firms as they seek cost or quality advantages over competitors. In healthcare, the efforts of providers alone are insufficient, and improvements in the value we obtain require concerted effort by consumers and policymakers in several directions. These include finding the political will to create incentives for prevention and to reduce medical errors, creating and adopting an information infrastructure that allows the tracking of disease, and dissemination of evidence

based information, and could greatly increase the efficiency of our healthcare system. These subjects are covered elsewhere in this issue of *Oregon's Future*, so we will focus on the importance of life style choices and of research that evaluates healthcare interventions. *(Please see the side bar "Worth: What are we willing to pay?" —Ed)*

Over the course of the 20th century, life expectancy in the United States has increased by roughly 30 years to 74.4 for men and 79.9 for women in 2001. Much of this gain occurred in the first half the 20th century when medical ability to prevent and treat diseases was limited, and can be attributed to factors such as improved nutrition, living conditions, sanitation, and water. To this day, factors such as diet, lifestyle choices, and environmental factors are better predictors of health outcomes than the amount of healthcare an individual receives. Smoking, alcohol and drug abuse, and unsafe sex contribute to the burden of disease and premature mortality. The burgeoning obesity epidemic threatens to stop, and potentially reverse the trend of improvement in life expectancy and health in the US and Oregon.

From a policy perspective, promoting healthy lifestyles is a difficult task. However, as the experience of poor countries such as Uganda and Thailand that have successfully stemmed the AIDS epidemic shows, it is not impossible even when resources are scarce. Effective promotion of healthy lifestyles requires concerted action from both within and beyond the healthcare system. Increasing public awareness of the consequences is a prerequisite first step towards encouraging healthy choices. Improved lifestyle choices including better food and recreation will lead to longer, healthier lives, and possibly to smaller healthcare expenditures.

How de we determine the value of interventions?

In addition to better lifestyle choices, continued improvements in knowledge are crucial to getting better value for our healthcare dollars. Although the state of the art in health and medicine has made tremendous advances over the course of the 20th century, much remains to be learned. In a March 16, 2003, New York Times article on the nature of progress in medical knowledge, Lisa Sanders, MD, recounts a remark made by the dean of her medical school that continues to ring true in her work as a physician and teacher of new physicians. Sanders recalls the dean saying to her class on their first day as medical students, "Half of what we teach you here is wrong—unfortunately we don't know which half".

At present, knowledge of which medical interventions and health policies yield good value for the resources they consume remains rudimentary. Economic evaluation of interventions to determine which among the currently available alternatives yield the best value can enable more judicious use of healthcare spending. An improved information structure that permits extensive analysis is necessary to make great strides in this area.

Economic evaluation of interventions can also have important long-term benefits. Many experts believe that the prevalence of third-party payment biases innovation in healthcare towards cost—increasing technologies—if patients' and physicians' choice of treatment is not sensitive to cost, the incentive to reduce cost is attenuated. A sustained effort to identify and promote interventions that yield best value can be an important part of a long-term cost containment strategy. This too requires a better information system. By increasing the likelihood that cost-reducing innovations will be recognized, adopted, and rewarded, it can counter the bias towards cost-expensive innovations in healthcare.

There is no predetermined appropriate level of health spending for a society. Whether the current level of spending is excessive depends on the value that additional spending yields. An inefficient system will entail billions of wasted dollars even if spending is reduced substantially. An efficient and high-quality system that yields improvements in longevity and quality of life can be well worth the expenditure even if spending continues to increase.

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