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This Hoover Institution ebook explores the hidden drivers behind America's soaring healthcare costs—from tax policy distortions to anti-competitive regulations and cross-subsidies in Medicare and Medicaid. Featuring insights from leading economists, it reveals how well-intentioned policies have created a system where costs spiral and innovation stalls. Discover why healthcare is so expensive—and what it will take to fix it.

IT IS NO SECRET THAT THE NATION'S HEALTH care system needs reform. Today, families face rapidly growing insurance premiums and out-of-pocket costs, making it difficult for many to purchase care. Whether measured per person or as a share of national income, the nation's health care spending dwarfs what other nations spend. And, worse, the costs are rising. A growing share of workers' paychecks go to health insurance premiums.

Meanwhile, the federal government now distributes over a trillion dollars in subsidies for Medicare, Medicaid, and other federal health care programs. The result is that Washington spends more on health care than it does on any other part of the budget, including national defense or Social Security.

HOW DOES TAX POLICY INCREASE HEALTHCARE COSTS?

There is not a single answer, but health care economists assign much of the blame to the "original sin" of health care policy: the preferred tax treatment for employer-sponsored insurance (ESI) premiums. If you buy a non-employer plan or pay for medical spending out of pocket, you typically use after-tax dollars. In contrast, if you buy health insurance through your employer, the premiums are paid with pretax dollars. The result is that there are significant tax incentives to choosing ESI plans with high premiums and low cost-sharing payments (e.g., copays, deductibles).

While this might seem like a technical tax issue, the consequences of health care's original sin are significant. High-premium plans mean people have little reason to consider the costs of their medical care. That leads people to make healthcare decisions where the costs of the procedures are far beyond the expected benefits. According to Economist Milton Friedman, the fundamental reason why we have high expenses is because most payments for medicine are third-party payments. The insurance company pays, the government pays.

But if you're my physician and I come to you, there's no payment between us. And as a result, everybody is spending everybody else's money and nobody spends somebody else's money as carefully as he spends his own.

WHY SHOULD PEOPLE HAVE TO GET THEIR MEDICAL CARE IN THAT WAY?

The problem really resolves itself into catastrophe vs ordinary with respect to ordinary medical care expenses. They're relatively modest, there's no reason why people can't pay for it on their own. The catastrophic expenses arise when you have a major thing. In most areas, we buy insurance only for catastrophic expenses. You don't insure your car in such a way that if you buy gasoline, you get repaid by the insurance company. The system that should have developed is a system under which people would buy insurance for catastrophic expenses. [1]

Economist Dan Kessler highlights several harmful effects of the policy. First, it makes employers and employers less sensitive to increases in their ESI premiums. That is because a dollar increase in premiums doesn't reduce one's after-tax income by a full dollar. Kessler explains why this is such a big problem:

It weakens the ability of competition among providers to keep prices low. This too makes sense. Why should doctors or hospitals compete vigorously when they know that their high prices can be passed on by insurers without much pushback?

Beyond its effect on the health care system, Kessler notes the tax exemption reduced 2020 federal tax revenues by $250 billion in 2020. Much of that tax savings went to high-income tax filers. The reason: high-income filers have higher tax rates and buy more expensive plans. Why did policy makers choose a health care policy that is costly, regressive, and produces bad incentives? Surprisingly, they did it by accident.

ADDITIONAL READING:

A simple fix can bring revolutionary change to health spending by: Daniel Kessler *via the Hill*

> A simple change to federal tax policy can bring health care prices down, while at the same time increasing government revenues and reducing inequality: Make insurance coverage of high-priced health care providers a taxable employee benefit.

Read more: https://thehill.com/opinion/healthcare/573965-a-simple-fix-can-bring-revolutionary-change-in-health-spending/

Whether it is a world war or a pandemic, authorities are quick to enact policies during a crisis to protect the public from harm. These policies are enacted with the best of intentions, but they often have long-term consequences that far outlast the crisis.

For example, during World War II, the government instituted wage and price controls to help with the war effort. But there was a problem. Businesses couldn't recruit enough workers without offering higher wages. To sidestep these restrictions, employers started paying for their employees' health insurance as a new benefit.

Businesses and workers then successfully lobbied Congress not to count health insurance as income, effectively making it tax free.

Wage and price controls were lifted after World War II, but the tax-free status of employer-paid medical care remained in place.

Today, the government is still subsidizing expensive employer-paid insurance. These plans give patients fewer reasons to consider the cost of their healthcare choices, encouraging them to use more care than they really need. Ultimately, this drives up medical costs and healthcare premiums for all.

If not for a temporary decision made in the midst of a world war, today's health care system would offer Americans more options and lower prices.

When a crisis happens, we expect our policymakers to respond. But we should remember that policies that sound good in the short term can have bad long-term consequences. [2]

WHERE IS THE COMPETITION?

The tax preference for ESI isn't the only reason costs continue to rise; another is a lack of competition. Competition is vital in well-functioning markets. Competition among businesses drives down prices and leads to better-quality goods and services.

For decades, riding in a taxi stayed the same miserable experience: they were hard to find, expensive, and unpleasant... at best, all because competitors were prevented from entering the market.

But then Uber and Lyft came along and figured out a way to challenge the local taxi cab monopolies. And what happened?

Prices dropped, rides became easier to find, and quality went up – way up.

THIS IS WHY COMPETITION IS FUNDAMENTALLY IMPORTANT.

Competition is the only force that consistently leads to lower prices and better quality goods and services, improving our daily lives.

If an industry is shielded from competition, companies within that industry can keep prices high, with little incentive to innovate

But as soon as a new competitor joins the market and does something better, faster, or cheaper, then the other companies can either adapt and compete to stay relevant, or not. Either way is a win for consumers.

Some businesses will succeed, some will fail. But as long as the market remains open to new competition, then prices will stay low and innovation will continue.[3]

In the case of health care, we find a lack of competition among medical providers, hospitals, and insurance companies. In a recent article, economist John Cochrane points to government regulations as the primary cause for the lack of competition. State certificate-of-need (CON) laws, for example, require government permission before someone may build a new hospital or expand operations.

Lawmakers hoped these rules would slow cost growth by stopping unnecessary hospital construction. But the result was the opposite; existing hospitals used CON laws to stop competitors from entering the market, driving up prices.

ADDITIONAL READING:

After the ACA: Freeing the market for health care by John Cochrane *via The Future of Healthcare Reform in the United States*

> Most of the policy discussion is focused on health insurance. But the health care market is dysfunctional, and needs to be fixed as well. Where are the Southwest Airlines, Walmart and Apple of health care, bringing cost saving, efficiency, and innovation?

Read more: *https://www.johnhcochrane.com/news-op-eds-all/after-the-aca-freeing-the-market-for-health-care*

Strict medical licensing rules also prevent much-needed competition. While these rules are ostensibly written to protect patients, existing providers often use these rules to keep qualified competitors out. Cochrane explains:

> **I am not arguing that we have to get rid of licensing. But licensing for quality does not have to mean restriction of supply to keep wages up— including state-by-state licensing, restriction of residency slots, restrictions on the number of new medical schools, and restrictions that encourage overuse of doctors where they are not needed.**

Cochrane continues:

In most industries, it’s easy to identify innovators.

But it's rare to hear of a new and disruptive health care provider that has made something better, faster, or cheaper. Why is that?

In short, it's because health care is a uniquely uncompetitive market.

Take price visibility - when consumers can compare prices, it forces businesses to compete. But in health care, you almost never know what you owe until after a service has been performed.

The most important driver of revolutions in price and quality, comes from NEW companies entering a market.

But we've passed thousands of laws and regulations that make it next to impossible for new competitors to offer medical services at a lower cost.

For example, health care providers in 35 states must obtain “certificates of need” in order to open a new hospital or clinic, or even make major purchases. But the boards that grant them permission explicitly protect existing providers, at the expense of new competition.

The rules that regulate the provision of health care are set up to prevent new and innovative companies from offering better, more cost effective services.

If we want a revolution in health care, we should think more about expanding supply.

And to do that, we need to identify and eliminate the restrictions that prevent new entrants to the market. [4]

There are other examples of how well-intentioned government rules ultimately stifle competition in the health care market. The Affordable Care Act, for instance, created strict rules governing how insurance companies could price their health care plans. These rules limited how much insurers could charge patients with different health conditions.

While they were created with the best of intentions, the regulations have reduced competition among insurers.

Political scientist Lanhee Chen describes how these rules increased the number of American counties that only have just one health insurer:

What we're seeing is an acceleration in premiums, and this has happened over the last couple of years and it is going to continue happening as we go forward.

Fewer and fewer insurers want to sell Obamacare compliant policies, because they lose money on it!

Obamacare included in it large pots of essentially payoffs for insurers to participate in Obamacare, and what Republicans have said is basically, "No, we're not going to do this anymore."

And so insurers have said, "okay well if we're not gonna get the money, we're gonna have a very difficult time justifying why it is that we're offering insurance in marketplaces where we're going to lose money."

So what you see here is planned competition has come way down.

In 2018, the number of counties where there is only one insurer went from about one thousand to over sixteen hundred.

So what do we know?

Competition goes down, prices go up as well. [5]

HOW DO MEDICAID AND MEDICARE CONTRIBUTE TO HIGH COSTS?

Government policies contribute to high health costs in other ways too. In the case of Medicare and Medicaid, the government reimburses doctors and hospitals at rates far below what private insurers pay. That's a good deal for the government, but the result is that hospitals and providers end up charging private insurers and patients more to make up the difference.

John Cochrane summarizes this arrangement:

The government wants to subsidize health care for poor people, chronically sick people, and people who have money but choose to spend less of it on health care than officials find sufficient. These are worthy goals, easily achieved in a completely free-market system by raising taxes

and then subsidizing health care or insurance, at market prices, for people the government wishes to help. But lawmakers do not want to be seen taxing and spending, so they hide transfers in cross-subsidies. They require emergency rooms to treat everyone who comes along, and then hospitals must overcharge everybody else. Medicare and Medicaid do not pay the full amount their services cost. Hospitals then overcharge private insurance and the few remaining cash customers.

Cochrane explains what is needed to keep this complex system of cross-subsidies in place; namely, the government must limit competition so providers and hospitals can overcharge private insurers and patients without worrying about new entrants.

Why is paying for health care such a mess in America? And why is it so hard to fix? Cross-subsides are a root cause of the problem: The government wants to help a group of people, so it forces businesses – doctors, hospitals, health insurers – to undercharge those people. To make up for the lost money, the government allows those businesses to overcharge someone else.

But, in order for this scheme to work, the government can't let other or new health providers and insurers offer better or cheaper care to the people who are overcharged. So the government has to enforce monopolies and stifle competition.

Stifling competition in any market removes the pressure to innovate, to lower costs, or to improve service for consumers. And soon everybody, even the people getting the subsidy, pays more than they would in a competitive market.

The government wants to help the elderly and the poor pay for health care. But lawmakers do not want to be seen taxing and spending, so they force doctors, hospitals, and insurers to do it.

ADDITIONAL READING:

The Curse of Cross-Subsidies by John Cochrane *via Hoover Digest*

> Today we subsidize health care for those who can't pay and overcharge the rest. A free market in health care would do neither.

Read more: *https://www.hoover.org/research/curse-cross-subsidies*

Medicare and Medicaid programs pay hospitals and doctors less than the cost of treatment. The government mandates that hospitals provide emergency care to everyone, regardless of whether they pay. Health care providers make up the difference by overcharging people with private insurance, or cash-paying customers. In return, the government makes it hard or impossible to start new hospitals or insurance companies that cater to young, healthy, and cash-paying customers.

This is an old game. The federal government used to require that telephone companies provide landlines at low cost, especially to rural areas. So it forced a cross-subsidy from overpriced long-distance calls. The government enforced telephone monopolies to keep new phone companies out and long-distance prices up. When telephone service was deregulated, costs for everyone plummeted, and the quality and quality of service grew enormously. Now we take cell phones for granted.

Just like phone company of the 1960s, continued reliance on cross-subsidies within the U.S. health care system will just lead to larger and larger costs and less and less efficiency. We talk about competition and transparency, forcing hospitals to disclose prices for example, but the government cannot allow competition and transparency as long as it insists on funding care for some people by overcharging others.

If the government wants to subsidize health care and insurance for the poor, elderly, and other groups, it should do so directly and on-budget. And raise the money for it honestly and forthrightly through taxes. It should then leave markets free to compete ruthlessly for the rest of our business. There is no fundamental reason that in order to help people in need, your and my health care and health insurance must be so thoroughly screwed up.[6]

Taxing and spending is not good for the economy, but it's better than cross-subsidization. It allows most people's health care and insurance to be provided by an unfettered competitive innovative market. It ensures voters can see where their money is going, and decide if they want to be more or less generous and to whom. The taxes would be unpopular, but our health bills would go down far more than our taxes would go up, and the quality and efficiency of our health care would skyrocket.

CONCLUSION

The high cost of US health care isn't a secret, but as we have seen the reasons for the high costs will not be easy to fix. Politicians across the political spectrum have attempted to reduce the tax preference for ESI plans with little success. And there have been many efforts to encourage more competition among health care providers and insurers.

ENDNOTES

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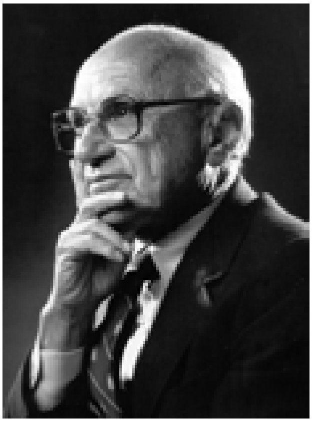

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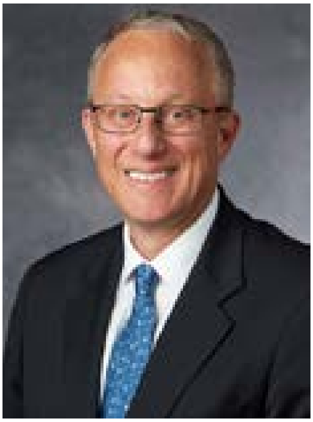

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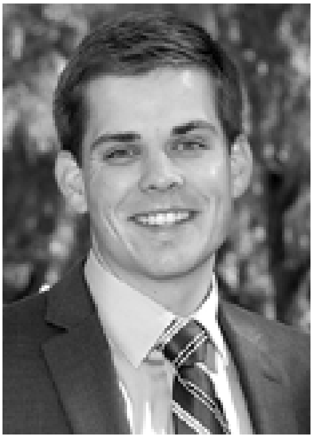

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