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Time to Shrink the Wedge in Health Care Costs

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How will health reform that's likely to come out of Congress effects the economy? Negatively.

At least that's the conclusion of a new report from the Tallahassee, Fla.-based firm of Arduin, Laffer & Moore Econometrics, "The Prognosis for National Health Insurance: A Minnesota Perspective."

Projecting the effects of reforms "based on President Obama's principles," the report estimates that "the net present value of all additional federal government expenditures through 2019" will be $1.2 trillion, or $4,412 for every person in Minnesota. These principles include a personal mandate to purchase insurance, required coverage of "preexisting conditions," minimum benefit levels set by Congress, and a subsidized insurance exchange.

These reforms would increase national spending on health care by another 8.9 percent over 10 years. They would also increase medical price inflation by another 5.2 percent, and reduce U.S. economic growth by 4.9 percent (and in Minnesota, by 4.8 percent) over a baseline scenario.

How do these costs come about? Blame an over-reliance on third-party payments, which the report dubs the "health care wedge." The wedge is "an economic separation of effort from reward, of consumers (patients) from producers (health care providers), caused by government policies." The separation is in part economic, but also clinical: "Decisions are made by government, insurers, and judges deciding medical malpractice liabilities." The report, which calls for decreasing the size of the wedge, says that current health reform proposals would increase it.

Government policy has already dramatically increased the wedge. The year before Medicaid and Medicare were created in 1966, government paid for only 25 percent of all health care spending. Today, it pays for close to half. Over the same time, out-of-pocket expenses declined, and now account for barely more than 10 percent of all health care purchases. No wonder, then, that roughly 70 percent of all people are satisfied with their own health care situation.

There are substantial though hidden costs to this policy environment. Under the accounting standards used by the Medicare trustees, that program has an unfunded liability of more than $30 trillion—several times the size of the U.S. economy. Governments in the U.S. spent less than 5 percent of their budgets on health care in 1960; today they spend over 20 percent.

Personal income, meanwhile, has shifted from wages to insurance. In 1960, wages accounted for two-thirds of all personal income, while today it's slightly more than half. Meanwhile, "supplements to wages" (largely but not entirely health insurance) have more than doubled over that period from 5.7 percent of total personal income to 12.5 percent.

Another problem is that health care inflation outpaces general inflation, and has for 50 years. One reason may be that fraud, waste, and abuse in health care spending amount to more than $2,300 per legal resident.

These facts are not coincidences. They come, at least in part, from the health care wedge. Government programs have expanded, and tax policies have encouraged employers to offer comprehensive coverage. As a result, neither patients nor health care providers act in ways that simultaneously improve quality and decrease costs of health care, a dynamic we have seen in other industries.

You may have noted the name Laffer in the name of the econometrics firm. If it’s familiar, that’s because it belongs to Arthur Laffer, the economist whose Laffer Curve was the intellectual genesis of the federal income tax cuts enacted under President Reagan. It’s no surprise that the report relies on the economic efficiency arguments made by supply-siders: Beyond a minimal level of government, government tax and spending policies decrease economic growth and have other adverse economic consequences. Health care is but one specific case of this dynamic, and it offers plenty of opportunities to consider the impact of various incentives on access to health care, state budgets, personal budgets, and the economy as a whole.

The report, which is distributed by the Freedom Foundation of Minnesota (www.freedomfoundationofminnesota.com/) [a prominent conservative nonprofit organization headed by Annette Meeks], concludes with proposals for “patient-centered health care reform” as a way to attack the 30 percent of health care spending that is wasted, and to extend insurance to some of the 30 million people it estimates who would still be left uninsured with an Obama-style reform.

These proposals include giving people the same tax credits for insurance that employers have, allowing the interstate sale of health insurance, and eliminating some regulations that make health care itself more expensive. It also calls for reducing the costs of Medicaid not through top-down approaches but by enlisting the power of consumers through providing vouchers for much of that program’s budget, as well as for having enrollees shop for health insurance.

The recommendations are certainly controversial, and won’t find favor with single-payer advocates. I wish, then, that this very short section (less than two pages) had been expanded to offer evidence why these proposals might work.