Government price fixing: health care edition [1]

Written by **Tim Worstall** [2] | Sunday 18 December 2011

You'll all be aware of the horrors with which the introduction of vaguely market like things into the NHS is causing our lefty bretheren. The idea that prices might be fixed by the supply and demand of something just makes them shudder. Surely they cry, government, the wise, fixing them would be better? After all, we don't want to end up with a health care system like that of America, do we?

Well, actually, no, we probably don't want to end up with the American health care system which is just why we don't want the wise, the government (sorry, that conjunction just makes me laugh so I've repeated it) fixing those prices. We'd much rather let markets do that for us.

For there's a very interesting recent paper which shows that the US health care system expensive as it is, is expensive because of government price fixing [3]:

> This raises the question of what exactly changed in the 1980s. Daeho Kim, a graduate student at Brown University, offers a provocative hypothesis in a new working paper [4]. As Kim explains, a 1983 Medicare reform created the prospective payment system, or PPS, which offered fixed reimbursements for the use of a medical technology. If a physician decides to use bypass surgery as a cardiac treatment, she won?t be paid on the basis of what it cost her to perform the surgery. Instead, she?ll be paid the national average cost. This way, there is a strong incentive to beat the national average cost of performing bypass surgeries, thus lowering, in theory, systemwide costs.

But something quite different seems to have happened. A big part of the story is that providers can choose from a number of different cardiac treatments, some of which are more expensive than others. PPS encouraged them to focus on the treatments where the marginal cost ? the cost of providing one more treatment, in this case ? fell below the average cost, even if there are more cost-effective treatments available. Kim suggests that PPS may account for one of the most distinctive aspects of the U.S. health system ? our extraordinary overreliance on costly treatments.

In short, the bureaucrats fixed the prices for a specific treatment but left the doctors and hospitals free to choose an expensive specific treatment over a cheap one. With the obvious effect that everyone now gets the most expensive possible treatment for whatever condition it is that they have.

Now one could argue that having the wise, those in government (it is to laugh again!), fixing the prices right this time would beat that problem. That is, in part, a bet that your average drone at the UK Department of Health is cleverer than your average drone at the US equivalent: good luck with that one.

But the real answer to that is that it isn't in fact possible to calculate, in the absence of a market, what is the correct price. For as Hayek pointed out, the whole thing is just too complex for that: the market is what we have to use to calculate the correct price. Thus it is impossible for the wise governors (*titter*) to ever get the price right: which is why we don't want them setting prices.

I'm perfectly happy for there to be government involvement in health care. I can see a valid place for social

insurance, I'm entirely fine with tax-financed health care of some kind. But in order to get the right amount of the best of it we're going to have to let the idiocy of the interaction of the marketplace replace all those very clever people in offices setting the prices for us.

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