Two Major Sources of the U.S. Health-Care Problem

***e*Research Corporation** is pleased to provide an article by Scott Grannis for his Blog, "Calafia Beach Pundit".

In this article, Mr. Grannis advocates the adoption of a freely-functioning market for the U.S. health-care industry.

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: **The two major sources of our healthcare problem**

You can also visit Scott Grannis' Home Page for his Blog at the link below:
http://scottgrannis.blogspot.ca/

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Bob Weir, CFA: Director of Research

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Two Major Sources of the U.S. Health-Care Problem

As I noted two weeks ago, the problem with Obamacare is that "it attempted to rejigger a huge fraction of the U.S. economy, and that is something that is virtually impossible to accomplish in a successful fashion by government diktat. Only a freely-functioning market economy can make something so huge and so complex work in an efficient manner."

So, the solution is to restore a freely-functioning market to the health-care industry. That sounds easy, but the complexities involved with undoing Obamacare are nearly intractable, and that is what has bogged down Congress' attempts to repeal and replace.

When faced with very complex problems, the best solution involves simplifying things as much as possible. Fortunately, John Cochrane has taken a giant step in that direction with his recent post. He has come up with what he refers to as the "two original sins" of health-care regulation. These two sins explain most, if not all, of the problems that we face with health-care today.

The first original sin appeared in the 1940s, when the government agreed to allow companies to deduct the cost of health insurance, but neglected to allow individuals to do the same. (I have discussed this in a number of posts over the years.) This made health insurance provided by employers much cheaper than health insurance purchased by individuals. Not only that, but it created a strong incentive for employers to offer health insurance which covered a whole lot of things; and, why not, if the costs were uniquely deductible by companies? Not surprisingly, the vast majority of us today get our health insurance either from our employer or the federal government, and most of the health-care policies offered (or mandated) today cover all sorts of trivial expenses—it is like buying car insurance that includes oil changes. As a result, only 10.5% of health-care expenses are paid for out of pocket, while the vast majority of expenses are paid for by third parties—consumers do not know what medical services really cost, and they don't care, so free market forces are absent. This tax distortion is also largely responsible for the problem of portability, since employees cannot take their insurance with them when they change or lose their job. We could fix this problem easily by simply changing the tax code to allow everyone to deduct their health-care insurance costs.

The second original sin, Cochrane argues, is that "Instead of straightforwardly raising taxes in a non-distortionary way (a VAT, say), and providing charity care or subsidies -- on budget, please, where we can see it -- our political system prefers to fund things by forcing cross-subsidies. Medicare and Medicaid do not pay what the service costs, because we don't want to admit just how expensive that service is. So, large hospitals make up the difference by overcharging you and me instead."

Instead of levying a tax designed to cover the cost of health-care for the unfortunate among us, we have chosen instead to use a system of cross-subsidies:

Cross-subsidies are dramatically less efficient than taxes. Cross-subsidies cannot stand competition. Low prices, efficiency, and innovation in the provision of services like health-care come centrally from competition, and especially disruptive competition. With no competition -- especially no entry by new doctors, hospitals, clinics, insurance companies -- costs spiral up. As costs spiral up, the cost of the charity care spirals up. As that spirals up, the size of the cross-subsidies spirals up. As that spirals up, the need to restrict competition spirals up.

Read the whole thing.

BW: See ABOUT THE AUTHOR below.

ABOUT THE AUTHOR

Scott Grannis was Chief Economist from 1979-2007 at Western Asset Management, a Pasadena-based, global manager of fixed-income portfolios for institutional clients.

He now enjoys keeping up on economics, markets, and politics from his condo overlooking Calafia Beach on the southern California coast, where he likes to think that he is immune to Wall Street group-think.

Married for 45 years to his Argentine wife, Norma, he has four children and five grandchildren (four boys and one girl).

He is a believer in supply-side economic theory, as practiced by his mentors, the late Jude Wanniski, Art Laffer, and Larry Kudlow. John Rutledge is another of his mentors, from the days that they worked together at Claremont Economics Institute.

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