Supply of Health Care

PH 126: Introduction to Health Economics and Policy
UC Berkeley

February 12, 2008

Outline

Market structure

Historical “Harvard” school of industrial organization:
structure-conduct-performance

Market structure

Structure

- the number of suppliers
- degree of product differentiation
- cost structure (returns to scale)
- vertical integration

determines the ...

Market structure

Conduct

- prices
- research and development
- advertising
- investment

which determines the ...

Market structure

Performance: measures of market efficiency

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Performance: measures of market efficiency

Eventually superseded by other theories because of advances in empirical and theoretical modeling techniques, but these categories are a good way of organizing different aspects of the supply-side of the market.

We will be talking about the structure of specific health care markets in upcoming lectures.

Efficient production

Three types of economic efficiency:

- Allocative efficiency
  Firms produce the products that consumers want and price equals marginal cost
- Distributive efficiency
  Goods are allocated to those that have the highest value for them
- Productive efficiency
  Production occurs at its lowest possible cost

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This condition comes as a result of *profit maximization*, but it is unclear if non-profit firms maximize profits or other factors.

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When a monopolist considers how much to produce, he weighs the benefit of making profit on another unit, but he would have to lower his prices on *every other unit* that he sells in order to sell one more. This is the idea of the *marginal revenue* curve.

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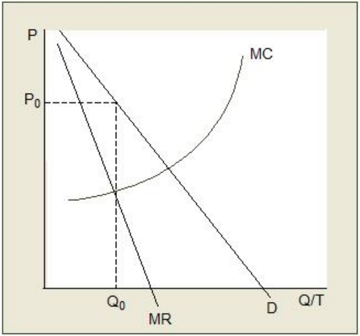

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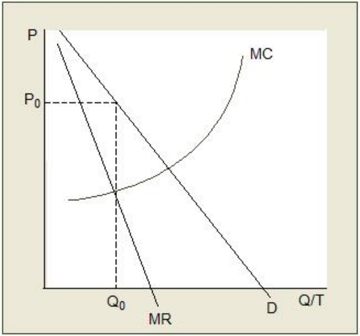


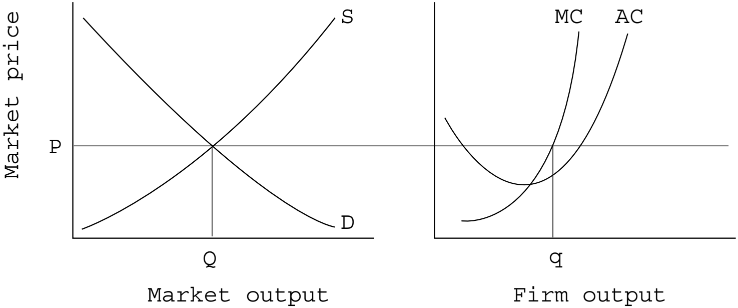
The federal government has become more willing to prosecute antitrust cases against health care providers.

Free entry

If there are no barriers to entry, then monopolies won't arise in the market because other firms will compete away the monopoly profits.

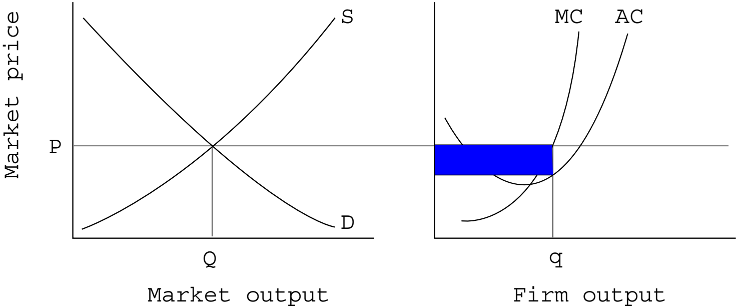
Assume that an industry is comprised of identical firms.

Free entry



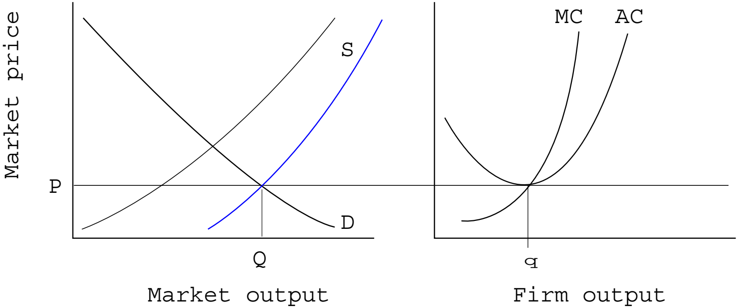
Market demand and supply set the market price and the firm produces until marginal cost equals price.

Free entry



But, because firms are producing at a point where price is above average cost, they are making short-run profits equal to the area of the blue rectangle.

Free entry



In the long-run, more firms enter, increasing supply from the black curve to the blue one. This increase corresponds to marginal cost equaling average cost for each firm and there are no short-run profits.

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Patients trust their doctors and receive excess treatment.

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If doctors already have plenty of patients, earn sufficient income, and have scarce time, they may not prescribe much more than necessary. But, if doctors want to increase their income or do not have enough work, they can increase the amount that they prescribe to their patients. This is called *supplier-induced demand*.

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Insurance companies can use the same techniques to combat this supply-side version of moral hazard as they do the demand-side variety. Additionally, they can offer profit sharing opportunities to their doctors or only work with doctors that have shown restraint in prescription (preferred providers).

Summary: Qualities of health care markets

What makes health care markets special?

- Patient's lack of information
- But the patient's asymmetric information relative to insurance companies (adverse selection)
- The agency role of physicians (supplier-induced demand; supply-side moral hazard)
- Comprehensiveness and structure of insurance (demand-side moral hazard)
- Ownership differences among firms (role of non-profits)
- Patenting to encourage research and development (monopoly rights)
- Licensing of professionals (barriers to entry)
- Ethical basis for treatment for all

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