## CONTENTS

*About the authors*  
*Preface*  
*Suggested pathways through the book*  
*Authors’ acknowledgments*  
*Publisher’s acknowledgments*  

### 1 Why health economics?

1.1 The health care economy is massive  
1.2 Health is uncertain and contagious  
1.3 Health economics is public finance  
1.4 Welfare economics  
1.5 A special note for non-American readers  

### DEMAND FOR HEALTH AND HEALTH CARE

2 Demand for health care  
2.1 Experiments on the demand for health care  
2.2 Is demand for health care downward-sloping?  
2.3 Measuring price sensitivity with elasticities  
2.4 Does the price of health care affect health?  
2.5 Conclusion  
2.6 Exercises  

3 Demand for health: the Grossman model  
3.1 A day in the life of the Grossman model  
3.2 An optimal day  
3.3 Extending Grossman from cradle to grave  
3.4 Comparative statics  
3.5 Unifying the Grossman model  
3.6 Conclusion  
3.7 Exercises  

4 Socioeconomic disparities in health  
4.1 The pervasiveness of health inequality  
4.2 The Grossman model and health disparities  
4.3 The efficient producer hypothesis  
4.4 The thrifty phenotype hypothesis  
4.5 The direct income hypothesis  
4.6 The allostatic load hypothesis 63
4.7 The productive time hypothesis 66
4.8 Time preference: the Fuch hypothesis 68
4.9 Conclusion 70
4.10 Exercises 71

II

SUPPLY OF HEALTH CARE

5 The labor market for physicians 78
5.1 The training of physicians 79
5.2 Physician wages 83
5.3 Barriers to entry 88
5.4 Physician agency 90
5.5 Racial discrimination by physicians 94
5.6 Conclusion 96
5.7 Exercises 96

6 The hospital industry 100
6.1 The rise and decline of the modern hospital 100
6.2 The relationship between hospitals and physicians 103
6.3 The relationship between hospitals and other hospitals 107
6.4 Nonprofits and hospital production 112
6.5 The relationship between hospitals and payers 115
6.6 Conclusion 119
6.7 Exercises 119

III

INFORMATION ECONOMICS

7 Demand for insurance 126
7.1 Declining marginal utility of income 126
7.2 Uncertainty 127
7.3 Risk aversion 128
7.4 Uncertainty and insurance 131
7.5 Comparing insurance contracts 135
7.6 Conclusion 137
7.7 Exercises 138

8 Adverse selection: Akerlof’s market for lemons 141
8.1 The intuition behind the market for lemons 142
8.2 A formal statement of the Akerlof model 143
8.3 The adverse selection death spiral 150
8.4 When can the market for lemons work? 152
8.5 Conclusion 155
8.6 Exercises 156

9 Adverse selection: the Rothschild–Stiglitz model 162
9.1 The $I_H-I_S$ space 162
9.2 Indifference curves in $I_H-I_S$ space 163
9.3 The full-insurance line 165
9.4 The zero-profit line 165
9.5 The feasible contract wedge 167
9.6 Finding an equilibrium 168
9.7 Heterogeneous risk types 170
9.8 Indifference curves for the robust and the frail 171
9.9 Information asymmetry and the pooling equilibrium 172
9.10 Finding a separating equilibrium (sometimes) 174
9.11 Can markets solve adverse selection? 177
9.12 Conclusion 179
9.13 Exercises 180

10 Adverse selection in real markets 184
10.1 Predictions of asymmetric information models 185
10.2 Adverse selection in health insurance 187
10.3 Adverse selection in other markets 190
10.4 What prevents adverse selection? 195
10.5 Conclusion 197
10.6 Exercises 198

11 Moral hazard 203
11.1 What is moral hazard? 204
11.2 A graphical representation of moral hazard 206
11.3 How to limit moral hazard 209
11.4 Evidence of moral hazard in health insurance 213
11.5 The tradeoff between moral hazard and risk reduction 217
11.6 The upside of moral hazard? 221
11.7 Conclusion 223
11.8 Exercises 223

IV ECONOMICS OF HEALTH INNOVATION

12 Pharmaceuticals and the economics of innovation 230
12.1 The life cycle of a drug 231
12.2 The uncertainty and costs of drug development 232
12.3 Patents 233
12.4 Induced innovation 240
12.5 Regulation of the pharmaceutical industry 244
12.6 Conclusion 249
12.7 Exercises 250

13 Technology and the price of health care 255
13.1 Technology and the rise in medical expenditures 257
13.2 New technology and medical inflation 262
13.3 Technology overuse: the Dartmouth Atlas 265
13.4 Theories to explain the Dartmouth findings 266
13.5 Conclusion 274
13.6 Exercises 275
### HEALTH POLICY

#### 15 The health policy conundrum
- 15.1 Arrow’s impossibility theorem
- 15.2 The health policy trilemma
- 15.3 How should health insurance markets work?
- 15.4 How should moral hazard be controlled?
- 15.5 How should health care provision be regulated?
- 15.6 Comparing national health policies
- 15.7 Conclusion
- 15.8 Exercises

#### 16 The Beveridge model: nationalized health care
- 16.1 A brief tour of the Beveridge world
- 16.2 Rationing health care without prices
- 16.3 Queuing
- 16.4 Health technology assessment
- 16.5 Competition in Beveridge systems
- 16.6 Injecting competition
- 16.7 Conclusion
- 16.8 Exercises

#### 17 The Bismarck model: social health insurance
- 17.1 A brief tour of the Bismarck world
- 17.2 Health insurance markets in the Bismarck model
- 17.3 Containing costs with price controls
- 17.4 Conclusion
- 17.5 Exercises

#### 18 The American model
- 18.1 Employer-sponsored health insurance
- 18.2 The managed care alternative
- 18.3 Medicare: universal coverage for the elderly and the severely disabled
- 18.4 Medicaid: subsidized coverage for the poor
- 18.5 Uninsurance
- 18.6 2010 health reform
- 18.7 Conclusion
- 18.8 Exercises
## CONTENTS

**19 Population aging and the future of health policy** 402
19.1 Why is the world aging? 403
19.2 Health care system sustainability 407
19.3 Forecasting the future of health expenditures 410
19.4 Policy responses to population aging 416
19.5 Conclusion 420
19.6 Exercises 420

**VI PUBLIC HEALTH ECONOMICS**

20 The economics of health externalities 428
20.1 Externalities in health 429
20.2 Pigouvian subsidies and taxes 434
20.3 The Coase theorem 437
20.4 The economics of organ transplantation 440
20.5 Conclusion 444
20.6 Exercises 445

21 Economic epidemiology 449
21.1 The demand for self-protection 449
21.2 The SIR model of infectious disease 454
21.3 Disease control 458
21.4 Applications of economic epidemiology 463
21.5 Conclusion 467
21.6 Exercises 467

22 Obesity 472
22.1 The widespread rise in obesity 473
22.2 What explains increasing obesity? 476
22.3 The costs of obesity 480
22.4 Is obesity a public health crisis? 482
22.5 Obesity contagion in social networks 486
22.6 Other justifications for public health intervention 488
22.7 Conclusion 490
22.8 Exercises 491

**VII BEHAVIOURAL HEALTH ECONOMICS**

23 Prospect theory 496
23.1 Modeling decisions under uncertainty 497
23.2 Misjudging probabilities 500
23.3 Framing 505
23.4 Loss aversion 507
23.5 A formal introduction to prospect theory 511
23.6 Implications for health economics 517
23.7 Conclusion 519
23.8 Exercises 520
24 Time inconsistency and health 525
24.1 The beta-delta discounting model 526
24.2 Time-consistent preferences 527
24.3 Time-inconsistent preferences: myopia and hot brains 529
24.4 Demand for commitment mechanisms 534
24.5 Behavioral welfare economics 538
24.6 Conclusion 542
24.7 Exercises 543

Bibliography 549
List of figures 574
List of tables 577
Index 579
1 WHY HEALTH ECONOMICS?

Almost everyone in the world has a good reason to care about health economics. The following quiz can determine whether or not health economics is important to you:

- Do you have finite resources to draw upon in case you get sick?
- Are you incapable of predicting the future with perfect accuracy?
- Do you live in a country that levies taxes on its citizens?

If you answered “yes” to any of these questions, health economics is important to your well-being, and understanding it can make you healthier and happier. (Or perhaps you will be happier once you get less healthy. We will discuss that possibility in Chapter 3.)

Health economics is not just an alphabet soup of esoteric acronyms like HMO and QALY. Nor is it an endless droning debate about arcane minutiae pertaining to the national budget. Instead, it is a lively field where we study real-life health decisions: why people lie to insurance companies about their health, why people smoke even when they know exactly how bad it is for them, and why health insurance might make you fat. Understanding health economics not only helps you make better decisions about your health, it is also inherently intriguing and compelling, even fun.

Understanding health economics is vital. Our argument rests on three facts: the health care economy is massive and expensive; health is a major source of uncertainty and risk; and governments around the world are deeply involved in financing health care systems.

1.1 The health care economy is massive

The gross domestic product (GDP) of the US in 2008 was just about $14 trillion. This means that $14 trillion worth of economic activity took place in the US that year. People spent money on a mind-bogglingly vast array of goods and services: meals at restaurants, baseball tickets, gasoline, new houses and cars, raw materials and machinery for factories, salaries for soldiers and schoolteachers, and retirement benefits (to name just a few).

Perhaps even more mind-boggling is the fact that one out of every six dollars spent in the US that year was spent on health care, to pay for things like checkups at the doctor’s office, bariatric surgeries, anti-cholesterol medicines, and new investments in medical research. This statistic is all the more shocking when we compare today’s mammoth health care sector to that of fifty years ago. In 1960, barely one out of every twenty dollars spent in the US went toward health care.

The trend has been similar in countries around the world, although no one spends quite as much on health care as Americans. In the past hundred years, the health care sector has grown massively across the developed world. Part of the story of this expansion in health care has to do with the wealth of scientific discoveries and technological improvements that have occurred in the last century, as we will see in Chapter 13. Today, billions are
Figure 1.1. Health care expenditure as a proportion of US GDP, 1960–present.
Source: Data from the US Center for Medicare and Medicaid Services, Office of the Actuary.

spent on insulin, antibiotics, chemotherapy, open heart surgery, and blood transfusions – but none of these things even existed in 1900.

The size of the health care sector also means that millions of people make a living working in the health care sector. In Chapters 5, 6, and 12 we will explore the role of doctors, hospitals, and drug companies in the health care economy, and learn about some unusual features of the markets for their services.

What do we get for all of this money we spend on health care? And are we spending too much or too little? Health care can certainly extend lifespans and improve quality of life, but then Americans, for all of their expenditures, are not the longest-living or healthiest people on the globe. These complicated questions are examined in much more depth in Chapter 14.

1.2 Health is uncertain and contagious

So the health care sector is quite large, but why are the economics of health any different from the economics at work in other, smaller markets, like the market for televisions or the market for bananas? Basic economic theory concludes that any competitive market, in the absence of externalities and asymmetric information, will produce an efficient outcome where there is no way to make anyone better off without making someone else worse off. Why should we assume that the market for health care is operating inefficiently or in need of any government intervention? For many years, economists did not treat health economics differently at all. But a seminal paper published in 1963 by Stanford professor Kenneth Arrow established health economics as its own field of study.

Arrow argued that health is different from other goods, and a source of “special economic problems,” for one major reason: uncertainty. Most people know roughly how many
television or bananas they are likely to buy in the next week, but demand for health care is highly uncertain. An unforeseen broken leg or heart attack can suddenly create demand for expensive health care services. Because most people are averse to risk, health-related uncertainty is unpleasant and, as we will see in Chapter 7, this uncertainty motivates individuals to demand health insurance.

The ubiquity of insurance in health care distinguishes it from other markets. Insurance markets are peculiar because they feature information asymmetries between buyers and sellers. Simply put, health insurance customers tend to know more about their health risks than insurance companies do. This would not be a problem if sickly insurance customers volunteered information about their health. But this is not in their self-interest because health insurers would charge them more for coverage. Instead, sickly customers have a strong incentive to masquerade as healthy customers. In a sense, most of the problems in health economics stem from the fact that people have every incentive to lie about their health. In Chapters 8 through 11, we will discuss the twin problems that arise in markets with information asymmetry: adverse selection and moral hazard.

Additionally, health care markets are rife with externalities because health status is a uniquely contagious quantity. It probably does not matter very much to you if your neighbor decides to purchase a television or eat a banana. But it certainly does matter if your co-workers decide to skip their flu shots or come to the office with tuberculosis. The fact that other people’s health decisions affect you – and that your health decisions affect others – can undermine the efficient functioning of markets. In Chapters 20 through 22, we discuss health externalities and the economics of public health.

### 1.3 Health economics is public finance

So health care is expensive, and health is a source of uncertainty and externalities. But what if you are healthy, face little risk of falling ill, and have generous insurance coverage to pay for treatment if you do? Even then, health economics should still be of interest to you because governments are deeply involved in the health care economy. Each year, the size of your tax bill depends greatly on the decisions of politicians and bureaucrats about how to manage your nation’s health care system.

The prominent role of governments in health care goes as far back as the 1880s, when German Chancellor Otto von Bismarck established a national health care system to gain political advantage over the Socialist Party. After World War II, more governments became extensively involved in health care markets as many countries introduced new government-financed insurance programs. Notable examples include national, single-payer health insurance systems like the National Health Service (NHS), in the UK and Medicare and Medicaid in the US.

By 2008, when one out of every six dollars spent in America was spent on health care, one out of every two of those dollars was spent by the government. And this is in a country with a health system that is relatively private. In countries like the UK, Sweden, and Canada, the government is responsible for the vast majority of health care expenditures. In Chapter 15, we introduce the range of health policy options that countries use to steward their health care systems.
The pressure on governments to finance the costs of health care will grow in the coming decades. As we will see in Chapter 19, increasing life expectancies and aging populations throughout the developed world will place enormous stress on public health insurance systems which are responsible for paying for health care. In addition, governments will have to cope with ongoing questions about whether or not to pay for expensive new medical technologies.

Together, these trends imply that health care will be an ever-growing item on government balance sheets. The critical role that governments play in health care means that all taxpayers – even healthy and rich ones – have a stake in ongoing political debates about uninsurance, cost-effectiveness, and the regulation of health care markets.

1.4 Welfare economics

Given the major role of government in health care, and the high stakes of the debate for taxpayers and patients, disagreement in health policy debates is inevitable. In practice, debates about health policy are among the most emotional and vociferous in all of politics. Sometimes these disagreements turn on normative issues, which are different ideas of how the world should be. Some people feel that adequate health care is a human right, while others feel that no government should be allowed to force anyone to purchase health insurance. These are philosophical questions that no amount of economic analysis can resolve.

But all too often these debates concern positive issues, which are different ideas of how the world actually is. One role of health economics is to decrease the level of unnecessary disagreement about health policy by determining positive facts. Do strict patent protections for newly developed drugs increase innovation? How much will it cost Medicare to pay for a new expensive type of laparoscopic surgery? Does a tax on fatty foods save money and make people healthier? How much would consumers save if individuals without medical degrees were allowed to offer health care services just like doctors? Unlike normative questions, these questions are amenable to careful economic reasoning.

In order to answer these questions, though, we need a coherent way of thinking that allows us to measure the costs and benefits of any policy proposal. Throughout this book we use the principles of welfare economics, an approach that will be familiar to most economics students. The central contention of welfare economics is that people know what is best for them. Their preferences – as revealed by their choices under constraints – are the best guide for determining good policy.

But welfare economics, as useful as it is for analyzing health economics, is not universally accepted. We end the book with Chapters 23 and 24, which cover prospect theory and time inconsistency, respectively. These chapters cover behavioral economics, a growing field that challenges the fundamental assumptions of the welfare economics framework and calls into question much of what we think we know about health economics.

1.5 A special note for non-American readers

If you live and receive health care in a country other than the US, a few of the topics we discuss in this book that make sense to American students will seem, well, foreign. In
many countries, including Canada and the UK, patients almost never pay directly out of their own pockets when they receive basic health care, except for peripheral services like dentistry and prescription drugs. But in the US, patients sometimes pay out of pocket for routine health care like flu shots and visits to the doctor.

Another major difference is that, in almost all developed countries, uninsurance is extremely rare or even nonexistent. Insurance is either provided for free by the government, or provided by a mix of public and private insurers. But in America, some people are not eligible for government insurance and cannot afford (or do not want) to buy private insurance.

Paying out of pocket for health care and going without insurance may be unfamiliar at first, but these concepts will come up over and over again in this book. This is because we focus largely on private markets for health insurance and for health care. This may seem a strange choice given that, as we have just pointed out, so much of the world’s health care is not delivered this way. But learning how health insurance and hospitals work in private markets is key for understanding two major health economics concepts: adverse selection and moral hazard. It is also crucial to understanding what motivates other countries to operate their systems in other ways.

Because the US currently provides the best examples of private health insurance markets and private markets for hospitals and doctors, much of the evidence we study will come from American data. Then, in Chapters 15 through 18, we will turn to a discussion of international health policy. By that point, we will have spent enough time understanding private markets to think intelligently about the vast array of policies in place in different countries. Understanding the economics of private health markets provides a deep insight into the functioning and tradeoffs implicit in public health provision.
Before we left for college, our parents counseled us always to follow the doctor’s advice and never to skimp on health care. If the doctor says get a flu shot, get one. If the doctor says get ten flu shots, get all ten—even if they cost $100 each.\footnote{One of the authors, despite being both a professional economist and a medical doctor, gives this questionable advice to his children.} While our parents’ counsel was loving advice, it implies that health care is so valuable that it is worth ignoring any and all economic tradeoffs. In the words of introductory economics, our parents are encouraging us to be \textit{price-inelastic} or \textit{price-insensitive} when it comes to health care.

\begin{figure}[h]
\centering
\includegraphics[width=0.5\textwidth]{figure2_1.png}
\caption{A price-inelastic demand curve, $D_I$, and price-elastic one, $D_E$. This chapter discusses which curve more accurately resembles the demand for health care.}
\end{figure}

Are people actually price-insensitive when it comes to health care? Or does demand for health care respond to price, even for health care that may be a matter of life and death?

Figure 2.1 shows two possible demand curves. $D_I$ reflects our parents’ advice: the individual with this demand curve is insensitive to price. He wants a certain level of care $Q_I$ and is willing to pay any price to get it. $D_E$, on the other hand, represents the demand of an individual sensitive to price. She takes price into account when deciding how much care to seek. A non-vertical curve like $D_E$ is said to be \textit{downward-sloping}.

Figure 2.1 may seem simple, but it lies at the center of health economics. Much of the policy debate about how best to organize the provision of health care is grounded in two questions:

\begin{itemize}
\item Is the demand curve for health care downward-sloping? Put another way, are people sensitive to the price of health care?
\item If the answer to the above question is “yes,” people who face different prices or have different willingness to pay get different amounts of care. Do they end up with different health outcomes as a result?
\end{itemize}

If the answer to the first question is “no,” and the demand curve for health care resembles $D_I$, then the economics of health and medical care is of little interest. The incentives of patients seeking care are inconsequential; instead, there exists a medically optimal level
of health \((Q_i)\). Achieving that optimum is a medical problem to be solved by doctors and medical researchers. It is not an economic problem to be solved by utility-maximizing consumers. In this world, health economics is an accounting exercise involving the comparison of different medical treatments and the measurement of different medical outcomes. Health economists studying incentives and markets have little to add.

But the evidence we outline in this chapter overwhelmingly suggests that the answer to the first question above is “yes” – consumers are price-sensitive when it comes to medical care. People with different budget constraints, different life expectancies, different qualities of life evaluate the tradeoff between medical care and other goods differently. One person may decide to skip a knee replacement surgery to pay for his child’s tuition. Another person may decide to get laser eye surgery rather than a fancy Christmas gift for his spouse. Determining the right amount of care is not merely a medical matter, but is the outcome of economic tradeoffs that balance the marginal cost of care against the marginal benefit of that care. In other words, demand for health care is downward-sloping.

In many countries, this is rarely an issue because all citizens are entitled to subsidized health insurance or are eligible for free care from the government. But in some countries, notably the US, people must routinely decide how much to pay for care. In those contexts, evidence suggests that people who face different prices or have different abilities to pay for health care receive unequal amounts of health care. But even in countries where patients pay nothing for care at the point of service, whether health care demand is downward-sloping has important consequences for the design of good health care policy, as we will see throughout the book.

Are people who can better afford health care healthier because they receive more and better care? If so, what should a society do, if anything, in response to this possible inequity? These questions underlie the ferocious political debate about health care in every country and motivate much of our study in this textbook.

2.1 Experiments on the demand for health care

Imagine a consultant working on his first case. He is tasked with helping a surgeon predict what will happen to her customer base if she raises prices. To do so, the consultant sets out to plot a demand curve for the surgeon’s services.

One method he might use to plot this demand curve is to take a survey of the surgeon’s patients and ask them if they would have chosen a different surgeon if the price had been higher or lower. One major problem with this approach is that it ignores the population of people who are not currently patients of the surgeon. A change in price for the surgeon’s services may have a different effect on that population. Since the surgeon’s patients are likely to be more devoted to her than patients who do not know her, they may be less sensitive to price changes than the people not surveyed.

Alternatively, the consultant could commission a survey of the entire local population. He asks respondents whether they visit surgeons like his client and how much they pay. The main advantage of this approach is that different groups of people – covered by different insurance plans – face different prices for surgical visits. This allows the consultant to construct a demand curve, since he observes different levels of demand at different effective prices. Unlike the first survey, respondents are not asked to conduct any hypothetical thought experiments.
But this survey design is also problematic because the prices that respondents face are not randomly assigned. People choose their insurance plans based on what is advantageous to them. For instance, a respondent who knows he is likely to require surgery will search for an insurance carrier that comprehensively covers surgical services. As a result, people with generous insurance – and therefore facing lower out-of-pocket costs – are exactly the people who are most likely to demand surgery in the first place.

This non-random selection distorts the estimated demand curve because the groups facing each price level differ in important ways. In this case, the people who choose generous insurance are sicker than the typical population, and consequently have higher demand for services. Conversely, people who choose less generous insurance are healthier and have lower demand. Figure 2.2 shows what the measured demand curve $D_M$ might look like if the true demand curve is actually $D_T$. Under these conditions, the consultant underestimates the demand at the high price $P_H$ and overestimates the demand at the low price $P_L$.

![Figure 2.2. True demand, $D_T$, and measured demand, $D_M$, in a non-randomized study. A non-randomized study such as a broad survey will tend to overestimate health care demand at low prices (and underestimate demand at high prices) because the people who face low prices are the same ones who purchased generous insurance coverage and tend to need more services.](image)

To calculate a true demand curve, we need to find how the same population reacts to different prices. Ideally, we would track the same population in two parallel universes where they face different price levels, but of course this thought experiment cannot be performed in real life. The next best alternative is a randomized experiment that assigns treatments randomly to different groups of study participants. Randomization generates experimental groups that are statistically similar. Done correctly, this becomes the best approximation for the parallel universes with actually identical groups. Distortions like the one in Figure 2.2 disappear if there are no meaningful differences between the groups except for the random assignment.

**Definition 2.1**

**Randomized experiment**: a study that assigns treatments randomly to different groups of study participants. A **randomized controlled experiment** includes a control group which is randomly chosen and receives either no treatment, a placebo treatment, or the usual treatment they would have received if not enrolled in the trial. Such studies provide the most persuasive evidence on questions of causality in the social sciences and medicine.
Two randomized health insurance experiments

For this chapter, we rely primarily on two influential randomized experiments of health care demand: the RAND Health Insurance Experiment (HIE) and the Oregon Medicaid Experiment. The RAND study, conducted between 1974 and 1982, was particularly groundbreaking because it was the first large-scale randomized study in which insurance status was randomly assigned, and it is still the only such study ever conducted in the US. Before RAND, there were many non-randomized studies but little consensus about the effects of price on the demand for health care. Since the RAND HIE was published, there has been little dispute that the demand curve for health care is not vertical but in fact downward-sloping.

For the HIE, the RAND researchers randomly assigned two thousand families from six American cities to one of several different health insurance plans for several years. These plans varied on the generosity of coverage; in particular, the plans had different copayment rates.

The copayment rate for an insurance plan is the fraction of the medical bill for which the patient is responsible. Thus, people assigned to different plans had to pay different prices for the same services. There were four different plans: one plan with completely free care (0% copayment rate), and three other cost-sharing plans with 25%, 50%, and 95% copayments. Because the plans studied in the RAND HIE differed in only this respect, they are ideal for estimating the effect of price on health care decisions.

<table>
<thead>
<tr>
<th>Definition 2.2</th>
</tr>
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<tbody>
<tr>
<td><strong>Copayment rate:</strong> the fraction of the medical bill for which the patient is responsible. A <strong>cost-sharing plan</strong> is one with a positive copayment rate, so that costs are shared between the insured and the insurer.</td>
</tr>
</tbody>
</table>

One problem with the RAND HIE is that the health economy has changed in fundamental ways since the 1980s. Consequently, the results found in the RAND HIE may not apply to the demand for health care today. A recent study, the Oregon Medicaid Experiment, provides an interesting update to the RAND results. In general, like the RAND HIE, the Oregon Medicaid Experiment finds downward-sloping demand for health care (Finkelstein et al. 2011).

Unlike the RAND HIE, the Oregon Medicaid Experiment did not assign participants to different insurance plans. Instead, it compared two groups of low-income adult Oregonians: (a) people who won a 2008 lottery to receive the opportunity to apply for public

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2 In addition to plans that varied on the copayment rate, there were also other plans including a health maintenance organization (HMO) plan and an individual deductible plan. Interested readers should check out *Free for All?* by Joseph Newhouse (1993) for an in-depth look at the experiment and many details that we lack the space to cover here.
health insurance coverage through Medicaid, and (b) lottery entrants who did not win and were not given a chance to apply for Medicaid. In effect, this lottery randomly assigned insurance coverage to a subset of the winners. Hence, the lottery winners tended to face lower out-of-pocket prices for care.

The approaches of the RAND HIE and the Oregon Medicaid Experiment each have their advantages and disadvantages. The Oregon Medicaid Experiment exclusively focuses on a low-income population, unlike the RAND HIE, which studied a nationally representative population. Furthermore, the RAND HIE used a direct randomization of health insurance coverage, while the Oregon Medicaid Experiment relied on a randomization scheme that was only indirectly related to insurance coverage (Medicaid enrollment was not automatic for lottery winners; they were only 25 percentage points more likely to be covered in the year following the lottery than the lottery losers were). Lastly, the Oregon Medicaid Experiment included an uninsured group that was in part randomly assigned, while the RAND HIE did not include any participants who were totally without insurance.

2.2 Is demand for health care downward-sloping?

If we wish to estimate a demand curve for health care, there are two basic questions to answer before we can even start: How do we define quantity, \( Q \)? And how do we define price, \( P \)? This may be simple in some cases: in the market for bubblegum, quantity is naturally defined as the number of sticks purchased and price as the cost of a stick.

Matters are more complicated when it comes to health care. A quick visit to the doctor’s office is not equivalent to an overnight stay at the hospital. Counting both as one unit of health care is not appropriate, nor is it clear if an overnight stay should count as five doctor’s visits or one hundred. Researchers handle this difficulty by measuring separate demand curves for different kinds of care.

Measuring price in health care is also not straightforward. Most health care is paid for by third parties such as private health insurers or the government. Unlike bubblegum buyers, patients pay a *premium*, or an upfront cost, to join an insurance plan, and in exchange they pay lower out-of-pocket prices for each medical service they receive. When calculating demand, the appropriate measure of price is the marginal cost that patients pay when consuming a fixed amount of care. Researchers treat the copayment rate as a measure of price because it is proportional to the marginal cost faced by patients.

The remainder of this section summarizes the experimental evidence on downward-sloping demand for different types of health care.

**Outpatient care**

If you have ever visited the doctor’s office, hospital, or emergency room and gone home the same day, you were the recipient of *outpatient care*. Depending on the severity of your condition, you may not care that your insurance company requires you to pay $20 for the visit. If you have a broken leg, you still want a cast set even if you have to pay the fee. On the other hand, if you just have a runny nose, you might choose chicken soup and *Simpsons* reruns instead of a visit to the doctor.
INDEX

Page numbers in italics refer to figures and tables.

access
to care 65–6
to drugs 249
see also gatekeeping
Accreditation Council for Graduate Medical Education (ACGME) 82
acetylsalicylic acid 230
actuarial fairness 133
acute myocardial infarction (AMI)
hospital competition and patient outcomes 112
price of survival 262–4
racial discrimination and treatment disparities 94–6
addiction
Grossman model 44–5
impatience and 490
rational 529
advanced directives ("living wills") 418, 419
advantageous selection 196–7
adverse selection
death spiral 150–2, 187, 188–9
definition 143
health insurance 187–90
Bismarck model 362–3
evidence against 189–90
Harvard University study 188–9
market solution 177–9
policy options 309–12
predictions of asymmetric information models 185–7
prevention 195–7
models see Akerlof model; Rothschild–Stiglitz model
other insurance markets 190–5
agricultural science 477
AIDS see HIV/AIDS
Air Force Academy study 487–8
Akerlof, G.A. 142
Akerlof model of adverse selection (used car market) 142–50
distribution of quality 144–5
government-set price controls 153–4
information assumptions 144–5
market unravels 148–9, 377
seller and buyer utility functions 144, 152–3
when do cars sell? 145–6
when will buyers buy? 147–8
which cars will sellers offer? 146–7
why not find a better price? 149–50
allostatic load hypothesis 63–4
altruistic-motive theory 114
American Association of Medical Colleges (AAMC) 89
American Medical Association (AMA) 88–9, 90
American model 322
defining features 372–3
PPACA reform (2010) 394–7
uninsurance 393–4
see also employer-sponsored insurance; managed care; Medicaid; Medicare
antibiotic resistance 432–4, 436–7, 439–40
arc elasticity 20
Arrow, K. 2–3, 114
impossibility theorem 306–7
asymmetric information
insurance 185–7
moral hazard 205
nonprofit hospitals 114–15
see also Akerlof model; Rothschild–Stiglitz model
Australia 217, 330, 341, 344–5
authoritarian commitment mechanisms 535
automobiles/cars
see Akerlof model
average cost-effectiveness ratio (ACER) 283
see cost-effectiveness
“baby boom” generation 408
Barker hypothesis see thrifty phenotype hypothesis
behavioral economics 490, 497
behavioral welfare economics 538–42
Pareto self-improving commitment mechanisms 541–2
perspectives 538–9
smoking interventions: role of paternalism 539–41
Bernheim, B. and Rangel, A. 533, 539, 540
beta-delta discount model 526–7, 530
Beveridge model 320–1, 328–9
competition 342–5
appeal of 342–3
unease with private markets 343–5
competition strategies 345–51
managerial autonomy 350–1
move away from global budgets 346–8
NHS internal market (1991) 345–6
patient choice 346, 348–50
reforms (2002–8) 346
elimination of price rationing 331
health technology assessment (HTA) 339–42
controversy surrounding 341–2
motivations for 339–40
rise of centralized 340–1
national systems 329–30
vs Bismarck model 367–9
see also queuing
Bismarck, Otto von 354
Bismarck model 321–2, 354–5
defining features 355
history 354
insurance markets 359–63
adverse selection 363–4
managed competition 359–60
risk selection and elimination 360–2
national systems 355–8
price controls 364–7
clinical distortions 365–7
gatekeeping 367–8
negotiating fee schedules 364–5
vs Beveridge model 367–9
blood donation 444
body mass index (BMI) 473
body weight, evidence of rise in 474–6
bounded rationality 499–500
British civil servants (Whitehall) studies 64, 65, 66
British National Cohort Study 60
bulk discount 186, 192–3
bulk markups 186
Canada
Amish farming community study 479
global budgets 346–7
health inequalities 55, 66
Medicare 330, 344
physician work-hours 83
prescription drug insurance 217
queuing 332, 338
cancer treatment costs 264
Hodgkin’s lymphoma 260, 261
cars see Akerlof model of adverse selection
(used car market); automobiles/cars
Certificate of Need (CON) laws 319
chargemasters 115–16, 117, 118–19
Chernobyl disaster 61–2
child mortality rates 67, 404–5
childhood deprivation: thrifty phenotype hypothesis 59–62, 67
childhood obesity 489–90
China Health Insurance Experiment (CRHIE) 15–16
choleciectomy 102
cholesterol (HDL) 56, 64, 65
clinical distortions 365–7
Coase, R. 437
Coase theorem 437–40, 442–3
cochlear implantation 366–7
Cochrane lifetime contract 179
coinsurance and copayment 209–11, 315
community rating 355, 359–60, 363, 396
comparative statics: Grossman model 42–5
competing risks problem 414
competition
managed 359–60
and patient outcomes 111–12
see also Beveridge model
compression of morbidity 412–13
compulsory insurance 311–12, 395–6
see also Bismarck model
Consolidated Omnibus Budget Reconciliation (COBRA) 379
consumption good 29, 33
contagion 428
in social networks 486–8
uncertainty and 2–3
copayment
coinsurance and 209–11, 315
rates 11, 12, 14, 15–16, 17, 19–20
cost–benefit analysis (CBA) 292–6
cost–effectiveness analysis (CEA) 279–82, 519
average cost–effectiveness ratios (ACER) 283
controlling moral hazard 314–15
HIV screening and lead poisoning 280–2
Medicare 315, 389
multiple treatments 282–5
cost-effectiveness frontier (CEF)  284–5, 292, 293, 294

cost of living (COL) index  263–4
cost measurement  285–7
   and effectiveness measurement  287–91
cost-sharing  209–11, 315
cost-shifting  118–19
“cream skimming”  360, 362

Cuba  472

Dartmouth Atlas Project  265–6
   lack of correlation between spending and health  266
   Medicare spending variations  265–6
   theories to explain findings  266–74
   local characteristics  269–71
   supply-sensitive care and moral hazard  272–4
defensive medicine  92–3, 270
delayed gratification and time-discounting  68–70

Delphi method  291
demand for health care  8–9
   downward-sloping  12–19
      inpatient and emergency room  13–17
      other  17–19
      outpatient care  12–13, 15–17
      pediatric  17
   experiments  9–12
      randomized health insurance  11–12
   other evidence  15–17
   price and health, relationship between  21–3
   price sensitivity measurement  19–21

diagnosis-related groups (DRGs)  102, 347, 387–8
dictatorship of the present  538–9, 540–1
differentiated product oligopoly  107–9
direct income hypothesis  62–3
direct-to-consumer (DTC) advertising  249
disability rates  412–13
disability-adjusted life years (DALYS)  288
discount function  526
drug industry see pharmaceutical industry

E-ZPass toll collection system  62
education
   and efficiency of producing health  42–3, 58–9
   time-discounting theory  69–70
efficient producer hypothesis  42–3, 58–9
elasticity of demand  19–21
emergency care
   demand for  13–17
   “last resort” laws  320
employer-sponsored insurance  312, 373–9
firm-specific human capital  374, 376–8
job lock  378–9
wage pass-through  374–6
end-of-life (EOL) care  417–19
endowment effect  509–10
epidemiological cost  450
epidemiology
   applications  463–7
      condom use in states with high AIDS prevalence  466
      falling HIV incidence in 1980s San Francisco  463–4
      flu vaccinations  466–7
      measles epidemic (1989–91)  464–5
      demand for self-protection  449–54
      disease as tax  449–50
      excess burden of disease  450–2
      prevalence elasticity  452–3
      disease control  458–63
      disease resilience  458–9
      smallpox eradication campaign  461–3
      vaccine demand and disease eradication  459–60
welfare economics of eradication  460–1
SIR model of infectious disease  414, 454–8
equality/inequalities see socioeconomic health inequalities

European Medicines Agency (EMA)  245, 249
ex ante moral hazard  205, 208–9, 214–15
ex post moral hazard  205, 208–9, 215–17
excess burden of disease  450–2
expected utility  128–9
   theory  498–9, 500
vs expected income  129–31
expected value  127–8

externalities  429–34
   antibiotic resistance  432–4, 436–7, 439–40
   Coase theorem  437–40, 442–3
   herd immunity  429–32, 434–6, 439–40
   organ transplantation markets  440–4
   Pigouvian subsidies and taxes  434–7, 443–4
   vaccination  460–1

fair and unfair insurance  132–3, 136–7
fee-for-service (FFS) system  102, 316
resource based relative value scale (RBRVS)  388
vs managed care  380–2, 383
firm-specific human capital  374, 376–8

flu
   H1N1 epidemic, Mexico  452–3
   vaccinations  466–7
Food and Drug Administration (FDA) 230–1, 240, 244, 245–6, 247, 249, 299
food industry 476–7
food price trends 477–8
Framingham Heart Study 486–7
France
  Bismarck model 358, 365, 367
  health care expenditure 318
  insurance 17, 312
  life expectancy 404
  medical education 79
  natalism 420
  nonprofit hospital sectors 320
  private hospital markets 319
free care 328, 331
Fuchs, V.R. 270
time preference hypothesis 68–70
full insurance
  and partial insurance 133–5, 136–7
Rothschild–Stiglitz model 165
gatekeeping
  Bismarck model 367–8
  managed care 213, 381
  and monitoring 212–13
  and queuing 315–16, 334–5, 337
  general practitioners (GPs) 334–5, 337, 338
generic drug makers 234–5, 237–8
Germany
  ex post moral hazard 216, 217
  fertility rates 405
  health care expenditure 318
  medical education 80
  nonprofit hospital sectors 320
  private hospital markets 319
  sickness funds 360, 362
  thalidomide 244–5
  see also Bismarck model
Ghana 214
global budgets 346–8
Gore, A. (US Vice-President) 391
government-failure theory of nonprofit hospitals 113–14
government-set price controls 153–4, 320, 365–6
Grossman model
  beta-delta discounting 527
  comparative statics 42–5
  aging and endogenous death 43–5
  education and efficiency of producing health 42–3
day in the life of 28–33
  market budget constraint 31–2
  production of H and Z 30–1
  sick time and productive time 32–3
  single-period utility 29
  time constraints within single period 29–30
  health capital 40–2
  health inequalities 42–3, 57–8, 62–3, 67–9, 308, 325
  obesity and food industry 477
  optimal day 33–9
  labor-leisure-health improvement tradeoff 37–9
  optimal H and Z within a period 35–6
  production possibility frontier for H and Z 34–5
  three roles of health in 33
  guaranteed renewable contract 179
hay fever 54, 55
health capital 33, 40–2
health care expenditure 1–2
  increasing 257–62
  see also aging population
health externalities see externalities
health indicators 22
health inequalities see socioeconomic health inequalities
health insurance see insurance; specific types
health maintenance organization (HMO)
  381–2, 383–4
health policy see policy
health production frontier (HPF) 322–4, 325
health production function (HPF) 268–9, 271
health resource groups (HRGs) 347–8
Health and Retirement Study 66–7, 192
health technology assessment (HTA) 278–9
  Beveridge model see under Beveridge model
  Bismarck model 367
  cost–benefit analysis (CBA) 292–6
  cost measurement 285–7
  effectiveness measurement 287–91
  prospect theory 519
  value of statistical life (VSL) 296–300
  see also cost-effectiveness analysis (CEA)
heart attack see acute myocardial infarction (AMI)
Helicobacter pylori 261
herd immunity 429–32, 434–6, 439–40
Herfindahl–Hirschman Index (HHI) 108–9
heuristics 511
high-density lipoprotein (HDL) 55–7, 64, 65
Hill–Burton Act 100–1
HIV/AIDS
  black market reimportation of drugs 237
  condom use in states with high prevalence 466
falling incidence in 1980s San Francisco 463–4
HAART and Medicaid 391
screening 280–1
and viatical settlements markets 193–4
Hodgkin’s lymphoma 260, 261
hospice care 418, 419
hospital bill 115–17
hospitalists 106–7
hospitals

differing amenities and spending 269–70
nonprofit 112–15
altruistic-motive theory 114
asymmetric information and failure of trust 114
costs and benefits 113
as for-profits in disguise 114–15
government-failure theory 113–14
and other hospitals, relationship between 107–12
competition and patient outcomes 111–12
differentiated product oligopoly 107–9
price competition 109–10
quality competition 110–11
and payers, relationship between 115–19
cost-shifting 118–19
hospital bill 115–17
uncompensated care 117
and physicians, relationship between 103–7
hospital experience vs physician experience 105–6
internal organization 103–4
rise of hospitalists 106–7
volume-outcome relationship and learning by doing 104–5, 112
rise and decline of 100–3
Hill–Burton Act 100–1
transition to outpatient care 101–3
hot-brain/cold-brain model 533–4, 539–40
hyperbolic discounting 530, 531
sophisticated and naive 535–6
impatience and addiction 490
impossibility theorem 306–7
income effect of moral hazard 222–3
income inequality hypothesis 53–5, 64–5
income-utility model 126–7, 129–31, 136, 162–4
incremental cost-effectiveness ratio (ICER) 280, 281–2, 282, 285, 292, 293, 314–15
indemnity insurance see fee-for-service (FFS) system

indifference curves 36
cost-effectiveness frontier (CEF) 292, 293, 294
insurance coverage 218
rationing 295–6
Rothschild–Stiglitz model 163–5, 171–2
Indonesia: iron supplement study 67–8
induced innovation see under pharmaceutical industry
infection hazard rate 463
infectious diseases
control 458–63
epidemiological cost and excess burden 450–2
prevalence elasticity 452–3
susceptibility-infected-recovered (SIR) model 414, 454–8
see also HIV/AIDS; vaccination
information asymmetry see asymmetric information
inpatient care, demand for 13–17
insurance
contracts 131–5
comparison 135–6, 137
see also Rothschild–Stiglitz model
declining marginal utility of income 126–7
full insurance 133–5
hospital bills 115–17
partial insurance 136–7
and price competition 109–10
prospect theory 517–18
social see Bismarck model
uncertainty 127–8, 131
universal 373
see also adverse selection; moral hazard; risk; specific types
internal rate of return (IRR) 85–6, 87–8
international medical graduates (IMGs) 89
investment good, health as 40
Israel
Bismarck model 357
decisions under uncertainty study 500
Japan
aging population 403–4
Bismarck model 354–5, 357–8, 363, 364–5, 366, 367
hospitals 102, 104, 319, 320
long-term care insurance (LTCI) 409–10
job lock 378–9
“July effect” 81
Kaiser Permanente plan 380–1
Kefauver–Harris Amendment 245–6
labor market
  declining physical labor 478–9
disincentive effects of Medicaid 391–3
  participation by women 479–80
  ratio of retirees to workers 404
labor-leisure-health improvement tradeoff 37–9, 45–7
Laspeyres price index 259, 260, 262–3
“last resort” laws 320
learning by doing 104–5, 112
liability insurance 93
Liaison Committee on Medical Education (LCME) 89
life expectancy 404–5
  and increased BMI 480–1
life insurance 191–3
lifetime insurance contracts 178, 179
“living wills” (advanced directives) 418, 419
long-run preferences 538, 540
long-term care insurance 194–5, 197
  Japan 409–10
loss aversion 507–11
malaria 67, 214, 243
malpractice and defensive medicine 92–3, 270
managed care 380–4
  backlash against HMOs 383–4
  competition between MCOs 110, 111
  research on effectiveness of 382–3
  rise of 380–2
mandatory insurance see Bismarck model; compulsory insurance
  marginal efficiency of capital (MEC) curve 40, 41, 42–3, 45–7, 57–8, 69
  marginal utility of income 126–7
  market concentration measure 108–9
see also Herfindahl–Hirschman Index (HHI)
means-tested insurance 312
Medicaid 389–93
  cost control 390–1
  PPACA reform (2010) 395
  structuring and financing 389–90
  uncompensated care 117
work disincentive effects 391–3
medical arms race hypothesis 110–11
medical care consumer price index (CPI) 258, 259
medical inflation see increasing expenditures under technology
medical training see under physicians
Medicare 16–17, 384–9
  Australia 330
  and Bismarck model 366
  Canada 330, 344
  cost control 387–9
cost-effectiveness analysis (CEA) 315, 389
cost sharing 315
diagnosis-related groups (DRG) payment system 102
end-of-life (EOL) care 419
expenditure 396–7, 408–9, 411–12
financing 386
history 372
hospital care 116, 117
PPACA reform (2010) 396–7
progressive or regressive? 386–7
structure 384–6
Medicare Trust Fund 408–9
mental health care 17
Mexico
  H1N1 flu epidemic 452–3
  Seguro Popular en Salud insurance program 213, 215
  monopoly rents 88, 90
moral hazard 203–4
  amount 208
  controlling 209–13, 313–17
  cost-effectiveness analysis (CEA) 314–15
  cost-sharing 209–11, 315
  deductibles 211–12
  gatekeeping and monitoring 212–13
  gatekeeping and queuing 315–16
  private and public insurance 313–14
  prospective payments and diagnosis-related groups 316–17
  queuing 332, 333
definition and examples 204–6
evidence in health insurance 213–17
ex ante 205, 208–9, 214–15
ex post 205, 208–9, 215–17
graphical representation 206–9
obesity 483–5
price distortion 205, 206–7, 208
and rationing 295–6
and risk reduction, tradeoff between 217–21
  private markets 220–1
  public markets 221
role of asymmetrical information 208–9
and supply-sensitive care 272–4
upside of 221–3
  extra preventative care 222
  income effect 222–3
morbidity, compression of 412–13
mortality rates 21–2
  child 67, 404–5
  competing risks problem 414
Cuba 472
historic 52
life insurance markets 191–2
and managerial autonomy 350–1
surgical 105
multi-period utility function: Grossman model 39–40
multiple treatments: cost-effectiveness analysis 282–5
naive and sophisticated hyperbolic discounting 535–6
natalism 419–20
National Health Service (NHS) see United Kingdom (UK)
National Institute for Clinical Excellence (NICE), UK 314, 329, 341–2, 343, 344
net present value (NPV) 84–5
Netherlands 60, 61
Bismarck model 357
New Zealand 341
nonprofit hospitals see under hospitals
Norway 338, 340–1, 349–50
nurse practitioners 89–90
nutritional information 488–9

obesity 472–3
contagion in social networks 486–8
costs of 480–1
evidence of rise in body weight 474–6
explanations for 476–80
declining physical labor and changing lifestyles 478–9
food industry 476–7
food price trends 477–8
genetic 476
labor force participation by women 479–80
side effect of good things 480
measuring 473
as public health crisis 482–5
moral hazard and health insurance 483–5
pooled health insurance 483
RAND HIE 485
public health intervention 488–90
childhood 489–90
impatience and addiction 490
nutritional information 488–9
rise in 473
“old-age incomes security hypothesis” 406
oligopoly 363–4
differentiated product 107–9
vs public provision 317
optimal day: Grossman model 33–9
optimal treatment selection 292–6
Oregon Medicaid Experiment 11–12, 13, 14–15, 17, 20, 21–3
access to care 66
moral hazard 213, 215, 216–17
proposal 391
orphan drugs, tropical diseases and 243–4
outpatient care
demand for 12–13, 15–17
price sensitivity measurement 19–20
transition to 101–3
palliative care 418
Pareto-improvement 145–6, 152, 429
commitment mechanisms 541–2
patents see under pharmaceutical industry
paternalism, role of 539–41
patient choice 346, 348–50
Patient Protection and Affordable Care Act (PPACA) 373, 394–7
“payment-by-results” system, UK 346, 347, 348
pediatric care, demand for 17
penicillin 242, 432–3
pharmaceutical industry 230–1
drug life cycle 231–2
history 230, 242, 244
induced innovation 232, 240–4
academic and public institutions 242–3
tropical diseases and orphan drugs 243–4
patents 233–9
consumer surplus and innovation, tradeoff between 235–6
in developing countries 236–8
price controls 238–9
price controls 238–9, 366
R&D costs 232–3, 235, 238, 239, 243, 245–6
regulation 244–9
controlled access to drugs 249
thalidomide 244–6
Type I and Type II errors 246–8
uncertainty 232–3
physicians
agency 90–3
defensive medicine 92–3
physician-induced demand (PID) 91–2, 273
barrier to entry 88–90
American Medical Association (AMA) 88–9, 90
implicit tradeoff 90
present-day 89–90
physicians – continued
and hospitals, relationship between see under hospitals
racial discrimination 94–6

evaluating treatment disparities 94–5
testing for inefficient 95–6
types 94
training 79–83
medical school 79
residency and “July effect” 80–1
work-hours 82–3
wages 83–6
returns to specialization 86–8
vs fee-for-service system 380–1

Pigouvian subsidies and taxes 434–7,
443–4

policy
aging population see under population aging
Arrow’s impossibility theorem 306–7
countering adverse selection in insurance markets 309–12
moral hazard dilemma 313–17
national comparison 321
health, wealth, and equity outcomes 322–3
health equity 325
health preferences 324–5
inherent health levels 323–4
models 320–2
regulation of provision 317–20
government-set price controls 320
private 319–20
public 317–19
trilemma 307–9
uses of value of statistical life (VSL) 299–300

pooled insurance
Kaiser Permanente plan 380–1
obesity 483
pooling equilibrium 172–4
see also employer-sponsored insurance

population aging
European population pyramid 402–3
fertility rates 405–7
health care expenditure 407–10
Japan: long-term care insurance 409–10
US Medicare 408–9
health care expenditure forecasting 410–16
compression of morbidity 412–13
future medical technology 410–12
models 413–16
life expectancy 404–5

policy responses 416–20
chronic disease prevention 416–17
end-of-life (EOL) care 417–19
natalism 419–20
reasons for worldwide trend 403–7
preferred provider organization (PPO) 381–2
prescription drugs, demand for 18–19
prevalence elasticity 452–3
price competition 109–10
price controls
government-set 153–4, 320, 365–6
pharmaceutical industry 238–9, 366
see also Bismarck model
price discrimination 237
price distortion 205, 206–7, 208
price elasticity 16, 17–18
measurement 19–21
moral hazard 205, 206–7, 208
price and health, relationship between 21–3
price leakages 237
price rationing, elimination of 331
prioritization strategy 338
private demand curve 430
private health care provision 373
regulation 319–20, 355
private hospital markets 319–20
probabilities, misjudging 500–5
production possibilities frontier (PPF) 34–5, 45–7
productive time hypothesis 66–8
property rights see Coase theorem
prospect theory 496–7
decision-making under uncertainty models 497–500
expected utility theory 498–9, 500
framing 505–7
implications of 518–19
demand for health insurance 518
health technology assessment 519
interventions and nudges 518–19
introduction to 511–17
editing stage 511–12
evaluation: value function 514–15
evaluation: weighting function 515–17
evaluation stage 513–14
loss aversion 507–11
endowment effect 509–10
importance of reference points 510–11
misjudging probabilities 500–5
overvaluing certainty 501–3
overvaluing small probabilities 503–4
prospective payments 316–17
public health 428
see also externalities; obesity
public health care provision 328
regulation 317–19
public hospitals 113
public institutions and pharmaceutical
innovation 242–3
public insurance
moral hazard 221
and private insurance 309–11, 313–14
quality competition 110–11
quality-adjusted life years (QALYS) 287–9, 292
surveys 289–90, 291
queuing 331–8
and gatekeeping 315–16, 334–5, 337
optimum length 333–5
pros and cons 332–3
reduction strategies 336–8
socioeconomic status and 336
welfare loss estimates from 335–6
racial discrimination see under physicians
RAND Corporation: new technology
predictions 411–12
RAND Future Elderly Model (FEM) 414–16
RAND Health Insurance Experiment (HIE)
11–12, 13, 14–15, 17, 20, 21–3
adverse selection 187
moral hazard 213, 214, 215, 216–17
obesity 485
randomized experiments
definition 10
health insurance 11–12
rare diseases 243
rational addiction 529
rationality
bounded 499–500
modeling 498
rationing 293–6
regulation see under pharmaceutical industry;
policy
retrospective payments 316
revealed preference 538, 540
risk
accurate prediction of 196
competing risks problem 414
and coverage, positive correlation between 185–6
heterogeneous types 170–1
and loss aversion 507–11
misperceived 195–6
unobservable 376–7
risk adjustment 362
risk rating 359
risk reduction see under moral hazard
risk selection
compulsory insurance 312
and elimination 360–2
Rothschild–Stiglitz model of adverse selection
completely private insurance vs universal
public insurance 309–11
feasible contract wedge 167–8
full insurance line 165
[IH-IS] space 162–3
indifference curves
in [IH-IS] space 163–5
for robust and frail 171–2
information asymmetry 185, 186, 187, 196
and pooling equilibrium 172–4
market equilibrium 168–70
robust and frail
firm-specific human capital 376–7
heterogeneous risk types 170–1
indifference curves for 171–2
separating equilibrium 174–7
single-payer system 310
zero-profit line 165–7
saving for retirement 536–7
screening, HIV/AIDS 280–1
selection bias 60
selective universal health insurance 311
self-protection, demand for 449–54
self-reported health status 53
separating equilibrium 174–7, 363
sickness funds 360, 361–2
single-payer systems 310, 328
smallpox eradication campaign 461–3
Smith, Adam 104
smoking
interventions: role of paternalism 539–41
time-discounting theory 69–70
social demand curve 430
social health insurance see Bismarck model
social loss
herd immunity 431–2
moral hazard 204, 206–7, 218, 219
social networks, contagion in 486–8
social surplus 431
social welfare 429
socioeconomic health inequalities
causal relationship 51, 71
and Grossman model 42–3, 57–8, 62–3,
67–9, 308, 325
health production frontier (HPF) 322–3,
324, 325
historical 52–3
hypotheses 58–70
income levels 53–5
non-human societies 56
socioeconomic health inequalities – continued
queuing 336
racial groups 56
SES health gradient 42
summary of evidence 56–57
universal health insurance 55
sophisticated and naive hyperbolic discounting 535–6
South Africa 363
specialists
limiting access to 367–8
wages 86–8
standard gamble (SG) 289–90, 519
Stanford University coinsurance study 216
State Child Health Insurance Program (SCHIP) 393
statutory health insurance (SHI) 356
subsidies
cost-shifting 118–19
mandatory private insurance 395–6
Pigouvian taxes and 434–7, 443–4
surveys
demand 9–10
quality of life 289–90, 291
survival curve 52
susceptibility-infected-recovered (SIR) model 414, 454–8
Sweden
Beveridge model 329–30, 340–1, 347, 349
health care expenditure 318
life expectancy 404
natalism 419
Switzerland
Bismarck model 356–7, 365, 367
community rating 363
comparative health economy 322–3, 324, 325
risk adjustment schemes 362
targeted and universal screening 280–1
tax(es)
disease as 449–50
Medicare 408–9
Pigouvian subsidies and 434–7, 443–4
technology
future 410–12
increasing expenditures 255–62
cancer and depression 264
heart attack survival 262–4
Hodgkin’s lymphoma and peptic ulcers 260–2
price index measure 258–60
limiting access to 367–8
overuse see Dartmouth Atlas Project
see also health technology assessment (HTA)
thalidomide 244–6
thrifty phenotype hypothesis 59–62, 67
time consistent preferences 527–9
rational addiction 529
time inconsistency 525–6
beta-delta discount model 526–7, 530
demand for commitment mechanisms 534–7
preferences 529–34
evidence for 531–3
hot-brain/cold-brain model 533–4, 539–40, 533
myopia 531
see also behavioral welfare economics
time preference: Fuchs hypothesis 68–70
time tradeoff (TTO) 289–90, 519
time-discounting theory 69–70
tort reform 93
tropical diseases 243–4
uncertainty
decision-making under 497–500
and demand for insurance 127–8, 131
health and contagion 2–3
pharmaceutical industry 232–3
uncompensated care 117
uninsurance 116, 117, 393–4
United Kingdom (UK)/National Health Service (NHS)
comparative health economy 322–3, 324, 325
fertility rates 405
Foundation Trusts 350–1
health expenditure 318
health resource groups (HRGs) 347–8
hospitals 112, 113
internal market 345–6
Liverpool care pathway (LCP) 418
Medicines Act 245
National Health Services Bill 328
National Institute for Clinical Excellence (NICE) 314, 329, 341–2, 343, 344
patient choice/“NHS Choices” 349, 350, 351
physicians 104
“August killing season” 81
“postcode lottery” 340, 341
queuing 332, 338
see also Beveridge model
universal health insurance 310–11, 328, 355
health inequalities 55
partial 373
universal and targeted screening 280–1
unobservable risk 376–7
utility function
  Akerlof model 144, 152–3
  von Neumann–Morgenstern 489–90, 502, 503, 505
  see also Grossman model

vaccination 460–1
  -preventable diseases 242
  demand and disease eradication 459–60
  flu 466–7
  rate: SIR model 455
  see also herd immunity

value function see under prospect theory

value of statistical life (VSL) 296–300

viatical settlements 193–4

visual analogue scale (VAS) 289

von Neumann–Morgenstern utility function 489–90, 502, 503, 505

vulnerable populations 23

wage pass-through 374–6

wages, physicians see under physicians

waiting times see queuing

welfare, private and social 429

welfare economics 4
  of eradication 460–1
  see also behavioral welfare economics

Whitehall (British civil servants) studies 64, 65, 66

women, labor force participation by 479–80

work see labor market