

November 14, 2005
Op-Ed Columnist

Health Economics 101

By [PAUL KRUGMAN](#)

Several readers have asked me a good question: we rely on free markets to deliver most goods and services, so why shouldn't we do the same thing for health care? Some correspondents were belligerent, others honestly curious. Either way, they deserve an answer.

It comes down to three things: risk, selection and social justice.

First, about risk: in any given year, a small fraction of the population accounts for the bulk of medical expenses. In 2002 a mere 5 percent of Americans incurred almost half of U.S. medical costs. If you find yourself one of the unlucky 5 percent, your medical expenses will be crushing, unless you're very wealthy - or you have good insurance.

But good insurance is hard to come by, because private markets for health insurance suffer from a severe case of the economic problem known as "adverse selection," in which bad risks drive out good.

To understand adverse selection, imagine what would happen if there were only one health insurance company, and everyone was required to buy the same insurance policy. In that case, the insurance company could charge a price reflecting the medical costs of the average American, plus a small extra charge for administrative expenses.

But in the real insurance market, a company that offered such a policy to anyone who wanted it would lose money hand over fist. Healthy people, who don't expect to face high medical bills, would go elsewhere, or go without insurance. Meanwhile, those who bought the policy would be a self-selected group of people likely to have high medical costs. And if the company responded to this selection bias by charging a higher price for insurance, it would drive away even more healthy people.

That's why insurance companies don't offer a standard health insurance policy, available to anyone willing to buy it. Instead, they devote a lot of effort and money to screening applicants, selling insurance only to those considered unlikely to have high costs, while rejecting those with pre-existing conditions or other indicators of high future expenses.

This screening process is the main reason private health insurers spend a much higher share of their revenue on administrative costs than do government insurance programs like Medicare, which doesn't try to screen anyone out. That is, private insurance companies spend large sums not on providing medical care, but on denying insurance to those who need it most.

What happens to those denied coverage? Citizens of advanced countries - the United States included - don't believe that their fellow citizens should be denied essential health care because they can't afford it. And this belief in social justice gets translated into action, however imperfectly. Some of those unable to get private health insurance are covered by Medicaid. Others receive "uncompensated" treatment, which ends up being paid for either by the government or by higher medical bills for the insured. So we have a huge private health care bureaucracy whose main purpose is, in effect, to pass the buck to taxpayers.

At this point some readers may object that I'm painting too dark a picture. After all, most Americans too young to receive Medicare do have private health insurance. So does the free market work better than I've suggested? No: to the extent that we do have a working system of private health insurance, it's the result of huge though hidden subsidies.

Private health insurance in America comes almost entirely in the form of employment-based coverage: insurance provided by corporations as part of their pay packages. The key to this coverage is the fact that compensation in the form of health benefits, as opposed to wages, isn't taxed. One recent study suggests that this tax subsidy may be as large as \$190 billion per year. And even with this subsidy, employment-based coverage is in rapid decline.

I'm not an opponent of markets. On the contrary, I've spent a lot of my career defending their virtues. But the fact is that the free market doesn't work for health insurance, and never did. All we ever had was a patchwork, semiprivate system supported by large government subsidies.

That system is now failing. And a rigid belief that markets are always superior to government programs - a belief that ignores basic economics as well as experience - stands in the way of rational thinking about what should replace it.

Bob Herbert is on vacation.