

The Undercover Economist

By Tim Harford, 2007. New York: NY Random House Trade Paperbacks, Pp. 288, \$14.95, paperback.

A major responsibility of most business economists is to explain economic concepts and analysis to laymen in easily understood ways. Unlike academic economists who can proceed in classroom settings within structured disciplinary frameworks, business economists typically must communicate in the restrictive contexts of memos, short meetings, or brief advocacy documents. The task is made more difficult if resistance to the message is posed by dogmatic preconceptions or unwillingness to think beyond the literal appearance of things.

The *Undercover Economist* is one of several recent attempts to popularize economics or make economics more accessible to laymen. It might suggest useful communication approaches to the business economist addressing issues covered in the book.

Issues surrounding the concepts of economic scarcity and market function are addressed in the first chapters. Prices reflect relative scarcity, which can be natural or contrived. Competition drives prices down to the marginal cost of production, but can be subverted by barriers to entry and other means. Markets don't operate optimally in the presence of externalities, which can be dealt with in theory but rarely in practice. The issue of "fairness," defined as an even allocation of wealth, was addressed by Kenneth Arrow who showed that lump sum taxes and payments could produce

fairness while preserving the desirable competitive market outcome.

An interesting discussion of price discrimination shows various ways that sellers try to get customers to sort themselves into groups with different willingness to pay. Discount cards and computer cookies contribute to data bases used to identify individuals' habits; periodic sales on merchandise in stores attract the customers who are not willing to pay regular price; making the coach cabin cramped and uncomfortable discourages those willing to pay for first class from buying cheaper seats; publishing less expensive paper backs after exploiting willingness to pay more for hard bound books. "Price gouging" and "ripping you off," i.e., marking up the price above the marginal cost of production, is accomplished in these and many other ways. These value-laden terms are used rather casually throughout and warrant additional discussion. Are you "gouged" by voluntarily paying a higher price than someone else when you reveal that you are willing to pay the higher price? We are told that price discrimination can be good, however, as in the case of pharmaceuticals sold in the United States substantially above the cost of production in order to fund research while the same pharmaceuticals are sold in poor countries at marginal cost.

Subsequent chapters deal with particular topics in economic analysis such as economic development, the formalization and application of game theory, the stock market tech bubble bursting of 2001, China's economic boom after the disastrous Great Leap Forward, and problems of the U.S. health care system.

Since I have a particular interest

in health economics, the chapter on health systems drew my attention, where Harford invokes Akerlof's analysis of asymmetric information: Because individuals have more information about their health status and future demand for health care than insurance companies, the U.S. market for health insurance cannot work. Akerlof's analysis is pertinent, according to Harford, because "the U.S. relies on private health insurance to provide much of the financing for medical costs," as opposed to Britain, Canada, and other countries. This assertion is astonishing, to say the least. Forty percent of U.S. health services are financed through government programs, and 26 percent are financed by business group plans. Insurance purchased by individuals accounts for less than 11 percent of health service expenditures. Consequently, a model of interaction between individual buyers and sellers of health insurance is not applicable to the U.S. system any more than to Britain or Canada.

The solution? Somehow, Harford gets to the root of the U.S. system's problem by suggesting that everyone should pay their own medical bills so they will have incentive to become informed and choose the most efficient approaches to their medical care. Insurance for catastrophic illness is OK, but everyone should have a savings account dedicated to medical expenses (to which the government can contribute for poor people). As proof that this approach will work, Harford cites Singapore's success with mandatory medical savings accounts and catastrophic insurance.

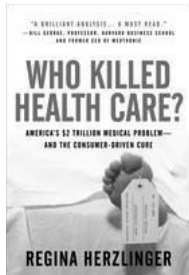
This book is an example of how one economist tries to inform the layman about economic explanations of many familiar phenomena. It might

provide the business economist with some ideas of how to approach this task.

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Who Killed Health Care? America's \$2 Trillion Medical Problem—And the Consumer-Driven Cure

By Regina Herzlinger, 2007. New York, NY: McGraw-Hill, Pp.304 , \$24.95 hardcover.



There are two powerful, well-respected and highly accomplished women who are driving the health care reform debate in the United States. And yet their agendas for reform are as different as night and day—or perhaps better yet, left and right. One is Senator Hillary Clinton (D-NY), former first lady and a presidential hopeful whose first attempt at dramatically reforming the U.S. health care system turned into a political disaster. The other is Harvard Business School economist Regina Herzlinger, one of the country's most knowledgeable and articulate experts on the U.S. health care system, who has been pointing the way toward a “consumer-driven” system for years.

These two reformers have radically different visions for how the health care system should work—though Senator Clinton might challenge that statement, claiming she has learned from her past efforts. One

vision gives the government more control over the health insurers, health care providers, and the options available to consumers; the other embraces an unabashedly strong commitment to putting the consumer in control.

Herzlinger herself identifies these two visions:

There are two broad sets of beliefs here. One group believes in the transformative powers of big, organized institutions, such as governments and large insurance firms. The other camp believes that small is beautiful. To them, only consumers and entrepreneurial institutions that serve them can transform health care.

One of these two visions will likely take precedence over the next few years, as the country engages in a prolonged debate over health care reform. It's important that economic principles, rather than political demands, guide that vision. With the publication of her very readable book, *Who Killed Health Care?*, Prof. Herzlinger has increased the chances that economic principles will rule.

There are two ideas underlying what Herzlinger calls the “big-is-beautiful” crowd: “First, this group believes that as a service industry, the health care sector is incapable of the kind of productivity gains that characterize the rest of the economy. Just as an orchestra's productivity cannot be increased by making it play faster, so too the productivity of health care is fixed.” But there is also a human side to the big-is-beautiful group: “Further, you and I are incapable of the kind of complex decision making that health care requires.”

By contrast, the “small-is-beautiful” group trusts consumers, in consultation with their doctors, to make

good decisions, especially when there is abundant information available. And those consumers—especially “marginal consumers”—will control costs. “The discerning, last-to-buy group consists of the picky, assertive people . . . who drive down price and improve quality for all the rest of us.” Combine those empowered consumers with entrepreneurial innovators and you have, according to Herzlinger, a prescription for a high-quality, low-cost health care system.

What Herzlinger does have in common with those who want more government control is the tendency to see a system that's broken. And not just broken but actually killing people. A recurring theme is a patient—or maybe I should say “victim”—named Jack Morgan, who dies because he needs a kidney transplant he never gets. The author also identifies what would have happened to Jack had the health care system functioned like a real market. Although Morgan is really just a composite of many patients, Herzlinger uses him as a foil to point out the five problems—what she designates as the “killers”—in the U.S. health care system: health insurers, general hospitals, employers, Congress, and the academics.

There is a bit of hyperbole in her approach. For example, although there is a chapter devoted to health insurers as killers—it's a little unclear whether they, and the others indicted, are killers of people or killers of a good health care system, or both—it really focuses on the rise and fall of Kaiser. A noble and innovative enterprise providing excellent care when it started, Herzlinger argues that the Kaiser HMO eventually lost its soul. And so lost its patients and a lot of money. She also discusses the problems with the more restrictive HMOs, why they flourished in the 1980s and '90s, and why

they could never be the solution they were promised to be.

Of course, there are many insurers who never adopted the HMO business model, much less the restrictive attitude that typified so many of them. While she does mention some of them in the book, such as Definity Health, she doesn't do much to juxtapose the good insurers against the "killers."

Some of her strongest criticisms are leveled at the hospitals, which for a number of years have engaged in a practice of charging the uninsured significantly higher prices than those with health coverage (and therefore likely to be in a network that negotiates reduced prices). "But some of the top executives of U.S. hospitals are cut from a different cloth . . . They are, purely and simply, empire builders. To support their empire building, they have suppressed the kind of competition and managerial innovations that could control costs, and they have acted less than charitably toward the poor uninsured."

What Herzlinger wants to know is where are the Sam Waltons of the hospital industry, entrepreneurs who figure out ways to provide consumers with more choices for increasingly lower prices?

After she has pretty much laid bare the problems facing the health care system and keeping it from acting like a real market, Herzlinger goes on to describe what it will take to fix it:

The fixes are not difficult.

We must get back the money our employers and government now take from our salaries and taxes to buy health insurance on our behalf so that we can choose it for ourselves. Our innovative, caring doctors must be empowered to design better, cheaper health care. Our poor should be subsidized by the rest of us, so they can buy health insurance just like everybody else. And our government should help subsidize the poor, provide transparency, and prosecute fraud and abuse. All the other busybodies must get out of the way—the empire-building hospitals, the micro-managing insurers, the self-seeking academics. Their role is to support, not to manage, us and our doctors.

Sounds like a plan to me! To learn the details of exactly how she makes those changes happen, you will have to read the book. And if you do, you'll see why, given a choice of visions for health care reform, Herzlinger's—the economist's—is the one that has to win.

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