



# The Council for Affordable Health Insurance's ISSUES & ANSWERS

Solutions for Today's Health Policy Challenges

No. 107

August 2002

## *Milton Friedman's Prescription for Curing the Health Care System*

In March 2001, Nobel Prize-winning economist Milton Friedman published an article entitled "How to Cure Health Care," analyzing the problems facing the U.S. health care system and suggesting some ways to fix it. According to Friedman, "The high cost and inequitable character of our medical care system is the direct result of our steady movement toward reliance on third-party payment. A cure requires reversing course, re-privatizing medical care by eliminating most third-party payment, and restoring the role of insurance to providing protection against major medical catastrophes." In this brief statement, Friedman identifies the system's major ailment and suggests that the only cure is to once again make health insurance the last rather than the first resort.

Most payments for health care are made by third parties: employers, the government or insurers. In 1999, seven out of 10 working individuals received their health insurance coverage through their job, according to the Employee Benefit Research Institute. Friedman points out that by 2001, the government was the single largest third-party payer, with its various programs paying for more than half of all U.S. health care.

While third-party payers finance much of the nation's health care, they also distort the system, according to Friedman. When third parties pay, they insulate consumers from the true cost of their health care. And this level of insulation renders consumers far less concerned with the cost of their care than they would be if they were paying the bills themselves. As a result, costs begin to soar. As the figure shows, health care premiums have been growing at very high rates, except for a period in the 1990s when managed care succeeded in slowing cost increases, in part by reducing utilization. But consumers have made it clear they no longer want those types of restrictions.

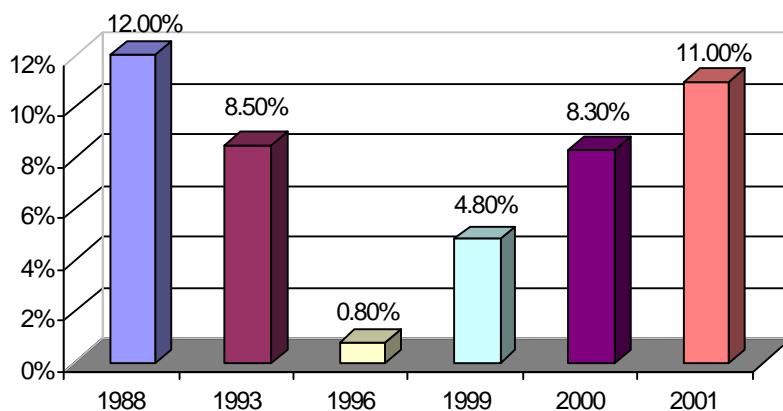
The same principle applies to virtually any array of goods or services.

If an individual is looking for a meal of a hamburger, fries and coffee, he has many choices. He can choose a fast food place for about \$4 or go to a nicer restaurant where the same order costs \$7. He bases his choice on either price or quality or some combination of the two. However, if someone else — a third party — is paying part of the cost, and the individual pays the same \$2 at either restaurant, he will most likely choose the nicer restaurant.

Now, if the owner of the more expensive restaurant learns that the consumer is paying a reduced or fixed amount, she may not be as concerned about maintaining a competitive price structure. If the restaurateur also learns that the consumer pays no more, or only a little more, for an appetizer and dessert, what happens? Why, the restaurateur encourages all her customers to enjoy these additional items. But while the customers pay little or nothing for the extra food, the restaurateur serves more food, her overall costs go up, and someone has to pay — in this case, the third party.

**Health Insurance Premium Increases, 1988 - 2001**

*Percent Increase Over Previous Year*



Source: Kaiser Family Foundation/HRET Employer Health Benefits Annual Survey, September 2001

Now, let's say the third party determines that the increased food purchased has pushed its costs too high. To constrain those costs, it tells all restaurants that it will no longer pay the amount that the restaurant bills it. Instead, it will pay only a calculated average rate that should be enough to cover the cost of these meals. Let's say that, based on its cost analysis, it decides the appropriate amount to reimburse all restaurants for a hamburger meal is \$4. Each restaurant also will get the consumer's \$2, for a total of \$6. Obviously, this is less than the original \$7 at the more expensive restaurant, but greater than the original \$4 at the fast food restaurant. So, what should we expect to see happen next?

Well, recall that due to the earlier billing arrangement the more expensive restaurant was able to attract most of the customers. However, at the \$6 reimbursement rate, not only can the restaurateur no longer provide an appetizer and dessert but she will have to cut back on the food quality or portion size of her basic hamburger meal. What happens at the fast food restaurant? It receives \$2 more than it was originally charging for the hamburger meal. If it can attract customers, its profit margins will soar. How will it appeal to those customers it had lost to the more upscale restaurant? One way to do so, and still have money to spare, is to offer a small salad or dessert. The extras may prove effective lures, even though they are not what the customers were originally looking for.

Now let's further complicate the scenario. What if the third party decides that in one part of the area it services it will reimburse only \$2 for any hamburger meal. This gives each restaurant a total of \$4. The more expensive restaurant may stop serving a burger with fries and coffee, as the owner finds she cannot provide it for \$4. The fast food restaurant will continue to serve it at the original \$4 rate, but without the salad and dessert to which customers have recently become accustomed. Right away, customers will begin to complain that they are not being treated fairly.

In the above example, as Friedman observes, the insertion of a third-party payer breaks down the financial controls naturally existing in an economic system, and the increased demand or utilization causes an overall increase in cost for the entire system. Breaking this cycle of increased usage followed by increased cost, Friedman believes, requires that we put consumers back in control of their health care expenditures.

To return control to consumers, Friedman supports the minimization or elimination of third-party payers. This would make the economic dynamics of health care similar to that of other insurance options such as homeowners and auto. For example, you purchase auto insurance to repair your fender in case of an accident, not to cover your oil and gas. To make this change all at once would mean the entire revamping of the current employer- and government-based health care financing system, which would be difficult to accomplish. What he proposes is a method of giving consumers more control by providing them with catastrophic insurance coverage and with funds to cover more routine conditions.

As a mechanism for the latter, he supports the expansion of Medical Savings Accounts (MSAs). These accounts put funds in consumers' hands so they can make payments for routine care just as they now make copayments. Yet the dynamic is different, since the MSA money they spend is their own. His premise is that since the funds in the MSA are owned by the consumer, the consumer will make spending decisions differently than he or she would do when the funds belong to someone else. This change in decision making ultimately will enable the consumer to regain control over health care spending, which in turn will lead to reduced utilization of services and more fiscally responsible behavior by providers.

Our legislative leaders should seize upon Milton Friedman's suggestions and immediately pass legislation that extends the MSA option to every American. Then, without further delay, they should reduce the role the government plays as a third-party payer. Putting the decisions for health care expenditures back in the hands of consumers is not only possible, it is essential.

---

Prepared by Rod Turner, FSA, MAAA, Vice President, American Republic Insurance Company

---

Copyright © 2002 The Council for Affordable Health Insurance

All rights reserved. Reproduction or distribution without the express consent of CAHI is prohibited.

Council for Affordable Health Insurance  
112 S. West Street, Suite 400  
Alexandria, VA 22314  
Phone: 703/836-6200 Fax: 703/836-6550  
Email: [mail@cahi.org](mailto:mail@cahi.org)  
[www.cahi.org](http://www.cahi.org)