



Adam Smith

1723 – 1790

Answer To The US Health Care Crisis

Penned by
Eldon Van Der Wege, MBA

Such nations, however, are so miserably poor, that from mere want, they are frequently reduced, or, at least, think themselves reduced, to the necessity sometimes of directly destroying, and sometimes of abandoning their infants, their old people, and those afflicted with lingering diseases, to perish with hunger, or to be devoured by wild beasts. Among civilized and thriving nations, on the contrary, though a great number of people do not labour at all, many of whom consume the produce of ten times, frequently of a hundred times more labour than the greater part of those who work; yet the produce of the whole labour of the society is so great, that all are often abundantly supplied, and a workman, even of the lowest and poorest order, if he is frugal and industrious, may enjoy a greater share of the necessaries and conveniencies of life than it is possible for any savage to acquire.

--An Inquiry into the Nature And Causes of the Wealth of Nations

There is a mad scramble on in the United States to contain raising health care cost while improving quality. The free market advocates believe a consumer-driven health care system would provide the necessary results just like in every other market. They would like to see competition among insurers increased with creative products like the low-cost, high deductible major medical insurance policy. They would move the regulation of insurance from the states to the national level to foster more competition. They would also increase the number of for-profit hospitals, believing they are more efficient than nonprofit hospitals. Milton Friedman and the conservative neoclassical economist champion a free market approach with reliance on individual responsibility to reduce the price of health care and improve quality.

But would the classical economist Adam Smith agree with such an approach? In the eighteenth century, the modern medical hospital began to appear, staffed with physicians and surgeons. The hospitals were founded by religious orders or from donations of wealthy individuals. The nobility, gentry, clergy, and local government funded the hospitals. Hospitals provided medical care for the sick, particularly the poor. Although Adam Smith never mentions hospitals, he does include the topics of insurance, physicians, and public works and institutions in his *An Inquiry into the Nature And Causes of the Wealth of Nations*.

Free Market And Self-Regulation

... Every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or order of men [business organization]. The sovereign is completely discharged from a duty, in the attempting to perform which he must always be exposed to innumerable delusions, and for the proper performance of which no human wisdom or knowledge could ever be

sufficient; the duty of superintending the industry of private people, and of directing it towards the employments most suitable to the interest of the society.

Adam Smith derived his free market theory from a historical study of commerce. He analyzed the causes of the slow development of wealth, both in ancient and modern times, as it affected agriculture, arts and manufacturers. The “arts” were occupations requiring manual or mechanical skill, like those of making clocks and watches. His theory is based on material goods that could be purchased or sold. He theorized that in commerce, government control is always harmful to the welfare of society. The self-regulation of the free market results in an efficient, wealthier nation. Thus, creating the greater good for everyone in the society.

Labor And Wages Of Physicians

Adam Smith views the labor of physicians as being quite different from the labor used in producing a commodity for the self-regulating market. The utility of their labor could not be accumulated over time. However, he believes that the market principles, which regulate other labor, should apply to the labor of physicians.

The labour of some of the most respectable orders in the society is, like that of menial servants, unproductive of any value, and does not fix or realize itself in any permanent subject; or vendible commodity, which endures after that labour is past, and for which an equal quantity of labour could afterwards be procured. The sovereign, for example, with all the officers both of justice and war who serve under him, the whole army and navy, are unproductive labourers. They are the servants of the public, and are maintained by a part of the annual produce of the industry of other people. Their service, how honourable, how useful, or how necessary soever, produces nothing for which an equal quantity of service can afterwards be procured. The protection, security, and defence of the commonwealth, the effect of their labour this year will not purchase its protection, security, and defence for the year to come. In the same class must be ranked, some both of the gravest and most important, and some of the most frivolous professions: churchmen, lawyers, physicians, men of letters of all kinds; players, buffoons, musicians, opera-singers, opera-dancers, &c. The labour of the meanest of these has a certain value, regulated by the very same principles which regulate that of every other sort of labour; and that of the noblest and most useful, produces nothing which could afterwards purchase or procure an equal quantity of labour. Like the declamation of the actor, the harangue of the orator, or the tune of the musician, the work of all of them perishes in the very instant of its production.

He also believes that the education of physicians and society's reliance upon their ability to make responsible decisions requires the remuneration for physicians to be greater than the common skills.

We trust our health to the physician; our fortune and sometimes our life and reputation to the lawyer and attorney. Such confidence could not safely be reposed in people of a very mean or low condition. Their reward must be such, therefore, as may give them that rank in the society which so important a trust requires. The long time and the great expence which must be laid out in their education, when combined with this circumstance, necessarily enhance still further the price of their labour.

He states that the proper performance of every service requires the compensation to be proportioned to the fundamental or essential characteristics of the service. The failure to do so would result in undesirable consequences.

If any service is very much under-paid, it is very apt to suffer by the meanness and incapacity of the greater part of those who are employed in it. If it is very much over-paid, it is apt to suffer, perhaps, still more by their negligence and idleness. A man of large revenue, whatever may be his profession, thinks he ought to live like other men of large revenues, and to spend a great part of his time in festivity, in vanity, and in dissipation.

Natural Monopoly

Adam Smith's free market theory was based on individuals, sole proprietors and partnerships, who risked their own capital and made their own decisions. These are the "self-regulating companies." He didn't see corporations as being self-regulating.

The trade of a joint stock company is always managed by a court of directors...The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.

He also sees that an exclusive privilege granted to a corporation or a self-regulating company was harmful to commerce. An exclusive privilege is a monopoly of trade established by royal charter or by acts of parliament. A monopoly keeps up the market price of particular commodities above the natural price, and maintains both the wages of the labor and the profits of the stock above their natural rate. However, there are exceptions to the general principle of exclusive privilege.

When a company of merchants undertake, at their own risk and expense, to establish a new trade with some remote and barbarous nation, it may not be unreasonable to incorporate them into a joint stock company, and to grant them, in case of their success, a monopoly of the trade for a certain number of years. It is the easiest and most natural way in which the state can recompense them for hazarding a dangerous and expensive experiment, of which the public is afterwards to reap the benefit. A temporary monopoly of this kind may be vindicated upon the same principles upon which a like monopoly of a new machine is granted to its inventor, and that of a new book to its author.

Another exception is made for natural monopoly. The concept of natural monopoly is regard as the work of John Stuart Mill. He developed his ideas from the works of Adam Smith and David Ricardo. Mill argued that it was wasteful to have multiple providers of utility services. But, neither Adam Smith nor John Stuart Mill refer to the situation they described as a natural monopoly. Adam Smith uses the phrase “without an exclusive privilege” to indicate a natural monopoly.

The only trades which it seems possible for a joint stock company to carry on successfully without an exclusive privilege are those of which all the operations are capable of being reduced to what is called a Routine, or to such a uniformity of method as admits of little or no variation. Of this kind is, first, the banking trade; secondly, the trade of insurance from fire, and from sea risk and capture in time of war; thirdly, the trade of making and maintaining a navigable cut or canal; and, fourthly, the similar trade of bringing water for the supply of a great city.

But before a corporation would be allowed to operate in this situation, two other conditions would have to be met.

To establish a joint stock company, however, for any undertaking, merely because such a company might be capable of managing it successfully; or to exempt a particular set of dealers from some of the general laws which take place with regard to all their neighbours, merely because they might be capable of thriving if they had such an exemption, would certainly not be reasonable. To render such an establishment perfectly reasonable, with the circumstance of being reducible to strict rule and method, two other circumstances ought to concur. First, it ought to appear with the clearest evidence that the undertaking is of greater and more general utility than the greater part of common trades; and secondly, that it requires a greater capital than can easily be collected into a private copartnery. If a moderate capital were sufficient, the great utility of the undertaking would not be a sufficient reason for establishing a joint stock company; because, in this case, the demand for what it was to produce would readily and easily be supplied by private adventures.

Insurance

Adam Smith believed that a natural monopoly (without any exclusive privilege) could successfully operate outside the self-regulating market. He sees the trade of insurance as a natural monopoly.

The value of the risk, either from fire, or from loss by sea, or by capture, though it cannot, perhaps, be calculated very exactly, admits, however, of such a gross estimation as renders it, in some degree, reducible to strict rule and method. The trade of insurance, therefore, may be carried on successfully by a joint stock company without any exclusive privilege.

Further, he gives the purpose for insurance.

The trade of insurance gives great security to the fortunes of private people, and by dividing among a great many that loss, which would ruin an individual, makes it fall light and easy upon the whole society. In order to give this security, however, it is necessary that the insurers should have a very large capital.

Public Works And Institutions

Political oeconomy, considered as a branch of the science of a statesman or legislator, proposes two distinct objects: first, to provide a plentiful revenue or subsistence for the people, or more properly to enable them to provide such a revenue or subsistence for themselves; and secondly, to supply the state or commonwealth with a revenue sufficient for the public services. It proposes to enrich both the people and the sovereign.

According to Adam Smith, the government has three important duties to perform: First, protecting the society from violence and invasion of other independent societies; Second, protecting every member of the society from the injustice or oppression of every other member by establishing an administration of justice; Third, erecting and maintaining public works and institutions.

Adam Smith believes that public works and institutions are necessary because they provide universally needed services or commodities to the greatest number of individuals. Furthermore, the profit from these works would be insufficient to cover all the costs, increasing and decreasing over time.

The third and last duty of the sovereign or commonwealth is that of erecting and maintaining those public institutions and those public works, which, though they may be in the highest degree advantageous to a great society, are, however, of such a nature that the profit could never repay the expence to any individual or small number of individuals, and which it therefore cannot be expected that any individual or small

number of individuals should erect or maintain. The performance of this duty requires, too, very different degrees of expence in the different periods of society.

The examples that Adam Smith uses for public works are natural monopolies like roads, bridges, navigable canals, harbors, and supplying a city with water. He also uses disease prevention in explaining the government attention needed in regulating a modern militia.

...Whereas to maintain, even in tolerable execution, the complex regulations of any modern militia, requires the continual and painful attention of government, without which they are constantly falling into total neglect and disuse...Even though the martial spirit of the people were of no use towards the defence of the society, yet to prevent that sort of mental mutilation, deformity, and wretchedness, which cowardice necessarily involves in it, from spreading themselves through the great body of the people, would still deserve the most serious attention of government, in the same manner as it would deserve its most serious attention to prevent a leprosy or any other loathsome and offensive disease, though neither mortal nor dangerous, from spreading itself among them, though perhaps no other public good might result from such attention besides the prevention of so great a public evil.

Using the example of maintaining roads, he recommends that the management of public works be at the local level. Placing it under the administration of trustees with oversight by the provincial legislature.

The tolls for the maintenance of a high road cannot with any safety be made the property of private persons. A high road, though entirely neglected, does not become altogether impassable, though a canal does. The proprietors of the tolls upon a high road, therefore, might neglect altogether the repair of the road, and yet continue to levy very nearly the same tolls. It is proper, therefore, that the tolls for the maintenance of such a work should be put under the management of commissioners or trustees.

Even those public works which are of such a nature that they cannot afford any revenue for maintaining themselves, but of which the conveniency is nearly confined to some particular place or district, are always better maintained by a local or provincial revenue, under the management of a local or provincial administration, than by the general revenue of the state, of which the executive power must always have the management.

The abuses which sometimes creep into the local and provincial administration of a local and provincial revenue, how enormous soever they may appear, are in reality, however, almost always very trifling in comparison of those which commonly take place in the administration

and expenditure of the revenue of a great empire. They are, besides, much more easily corrected.

He also believes that public works should cover most of their own expenses by generating their own revenue.

It does not seem necessary that the expence of those public works should be defrayed from that public revenue, as it is commonly called, of which the collection and application are in most countries assigned to the executive power. The greater part of such public works may easily be so managed as to afford a particular revenue sufficient for defraying their own expence, without bringing any burden upon the general revenue of the society.

Even where the reward of the master does not arise altogether from this natural revenue, it still is not necessary that it should be derived from that general revenue of the society, of which the collection and application are, in most countries, assigned to the executive power.

And if the public works can't cover all of their own expense, the remaining portion should come from the general revenue of society.

When the institutions or public works which are beneficial to the whole society either cannot be maintained altogether, or are not maintained altogether by the contribution of such particular members of the society as are most immediately benefited by them, the deficiency must in most cases be made up by the general contribution of the whole society.

He also believes that the public contribution should be based on the ability to pay.

The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state. The expense of government to the individuals of a great nation is like the expense of management to the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate.

Health Insurance In The United States

The biggest problem with the U.S. health care system is its failure to recognize health insurance as a natural monopoly. The population is fragmented not only into the insured and uninsured but further subdivided within the insured groups. This has impacted not only the economic efficiency of the health insurance industry but also the market for health care delivery. The failure to furnish an equivalent reimbursement to health care providers for services delivered to every patient disrupts the efficiency of the delivery

system. The differentiation of the population should take place at the time of paying an income-based health insurance premium, not at the point of delivering services. Health insurance premiums based on the ability to pay allows for an equitable and efficient method of collecting payments to provide coverage for everyone.

Operating health insurance as a monopoly increases efficiency and reduces cost. Besides efficiently spreading the risk of loss over the entire population, it greatly reduces administrative cost for the insurer and health care providers. The United States spends more on administrative health care cost than any other country. The administration of the fragmented multiple health insurance system accounts for more than 30 percent of the U.S. health care budget. Administrative health care cost increases as the number of health insurance companies and products increase. In other nations, single insurers spend a small fraction of their health care dollar on administrative cost. In changing to one insurer, there is more than enough savings in administrative cost to cover the health care cost for all of the uninsured in the United States.

For the United States health care system to be effectively reconstructed, major changes will have to be made at the state level. The current complex financing scheme must be replaced with an equitable and efficient health insurance program operated by a public mutual health insurance enterprise. All residents of each state would be insured in a single risk-pool at the state level. Annual actuarial calculations would determine income-based health insurance premiums. Regional health care districts would be established within a state to manage the health care program locally.

The micro-management and expense of federal government involvement would be dramatically decreased. The Medicare and Medicaid programs would be eliminated. The Medicare tax would be replaced by Congressional appropriations, transferring revenue from the Federal General Fund to a Federal Health Care Trust Fund. To make equitable health care available in each state, federal allocations to the states would take into account the state's personal income per capita relative to the national average, the size and age of the population, cost-of-living indices, and other factors.

Health Care Payments

The economic issue with health care providers is not whether market principles apply, but how to determine the reimbursement rate for services. Consumer-driven plans, with their high deductible, would require the patient to pay out-of-pocket for everything but catastrophic costs. However, the insurance companies with these plans would still contract with health care providers to determine the reimbursement rate for out-of-pocket patient services. With a consumer-driven plan, the first question asked of a patient would be "What's your insurance?" and "Are you able to pay?" not "What's wrong?"

Cost shifting occurs between insurers and the uninsured makes it difficult to determine reasonable reimbursement rates. High deductible plans further cause a financial burden on health care providers when patients cannot afford the out-of-pocket payment. Under a

single insurer system, a negotiated fee schedule could be established that pays a reasonable reimbursement for the services provided to every patient, thus eliminating cost shifting.

Multiple insurers limit the individual's right to choose their own health care provider. Every insurer has its own network of health care providers, making it difficult to have a real choice. This also leads to payment disagreements between the health care provider, patient and insurer when out-of-network providers perform the needed services. This causes loss productivity and additional costs for all the parties involved.

With only one insurer, the entire state would be in a single unified network. Individuals would have the choice of any health care provider within the state. The health care provider would be guaranteed a timely payment for all appropriate services.

Health Care Facilities

The free market advocates claim that for-profit health care facilities are able to provide better care at lower cost due to higher efficiency. However, studies have found that investor-owned health care facilities have higher costs and lower quality care than non-profit facilities.

For-profit health care facilities must maximize their profits for investors. Executives also maximize their own salaries, bonuses and stock options. This often means cutting variable costs, such as lowering the nurse-to-patient ratio. While in other situations, the fixed assets are underutilization causing incentives for unnecessary tests like MRIs and nuclear scanning while failing to provide the appropriate treatment.

For-profit health care facilities often duplicated services available at general hospitals while avoiding the uninsured patients by not providing emergency services. They select the lucrative patients and services while failing to meet the needs of the community. And in some cases, the for-profit health care firms have perpetrated fraud: performing cardiac procedures on healthy patients, offering kickbacks for referrals, exploiting Medicare loopholes to claim undeserved payments and inappropriately detaining patients to fill beds.

By assuring payment for services provided to every patient allows non-profit health care facilities to successfully compete with the for-profit firms. The market would no longer be segmented into the insured, under-insurer and the uninsured. The health care firm who provides better care at lower cost due to higher efficiency would survive no matter their profit status. Of course, wealthy individuals could still purchase extraordinary accommodations in a health care facility, such as a penthouse suite with a private nurse and personal chief, using their own money.

Conclusion

Now is the time to start acting as a civilized and thriving nation. Adam Smith's concern for the welfare of society, not the special interest of Milton Friedman, can solve the US health care crisis. Having one insurer, basing health insurance premiums on a person's ability to pay, allowing patients to choose their own health care providers, and assuring providers a reasonable reimbursement for services, the free market can once again use its "invisible hand" to efficiently provide quality health care for everyone.