

Third-Party Payers and Perverse Incentives

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July 18, 2012

To people who subscribe to the health policy orthodoxy, the riddle of modern healthcare is: Why are health costs rising so fast? To me the riddle is: why isn't health spending rising even faster?

Every time you and I spend a dollar at a physician's office, only 10 cents is coming out of our own pockets, on the average.^[1] The remainder is paid by a third party—an employer, an insurance company, or [government](#). That means our incentive is to consume healthcare until it's worth only 10 cents on the dollar to us. That's enormously wasteful. It means we are consuming healthcare that is worth 10 cents when with the same money we could have consumed something worth a dollar. Why do we do that? Because we are trapped. We are in a third-party payer system with use—it—or—lose—it benefits. Most of the time our health plan doesn't give us the option to buy less healthcare and more of something else.

With the advent of ACA, our incentives will become even worse. A long list of preventive services will be made available without any co—payment or deductible. Yet if the cost of these services to us is zero at the time we consume them, our incentive will be to consume them until the last bit is almost worthless.

Some Type A [personality](#) readers may be skeptical of the idea that people will overuse the healthcare system. Are we talking about a few hypochondriacs? Or, are we talking about ordinary people? The latter. In Florida, for example, the waiting rooms of many specialist doctors are gathering places for senior citizens who take the occasion to [socialize](#) and enjoy each other's company.

First—dollar health insurance coverage means healthcare is free or almost free at the time we obtain it. When something is free, our incentive is to consume it so long as it furnishes any value at all. Yet the reality is that these services are not costless. In fact, the way our system functions, they are very expensive. So although we consume care as though it were free, we all end up paying a very steep price through higher premiums and higher taxes.

As a practical matter, once we pay insurance premiums, that money is combined with everyone else's premiums in a pool. Once the money is in the pool, it is no longer "ours." In fact, when we draw from the pool, we are spending everybody's money. Moreover, the only way to get benefits from the health insurance pool is to spend money on medical care.

If you and I are in the same insurance pool, consider how many ways there are for me to spend your money:

- If my wife and I decide to have another child and we have fertility issues, there's always in vitro. Cost: \$20,000.
- If we decide not to have a child, there is always a vasectomy or tubal ligation. Cost: \$1,000 to \$7,000.
- If I decide my thinning hair needs to be a bit bushier, there's Propecia at an annual cost of \$842.
- If my [testosterone](#) level isn't in sync with my idealized vision of my own virility, there is Androgel (\$831/year).
- If my unhealthy [diet](#) leads to diabetes, many of those costs will become "ours" as well (average annual extra cost = \$7,000).

Notice I haven't even mentioned yet the normal diagnostic screenings (PSA test, colonoscopy, etc.). They cost money as well. Then, let's say that over time, I abuse my body with alcohol, tobacco, [drugs](#), fatty foods, lack of exercise, and so on. I know that others will pay my medical costs—mainly from first dollar—once I get old enough to qualify for Medicare.