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The Role of Pharmaceuticals in Health Care Reform

In the U.S., we spend too much on hospital care and too little on drugs. Billions of dollars are wasted every year because patients and their doctors choose expensive, hospital-based therapies instead of more cost-effective drug therapies. This waste and inefficiency is the result of the way we pay for health care, which in turn is the result of unwise government policies. Let's see why.

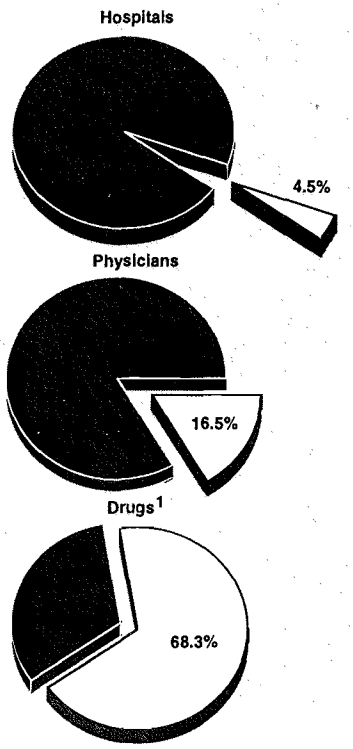
Third-Party Payment of Medical Bills. Because of widespread health insurance coverage, most of us pay for only a small portion of our medical care from our own resources. For the health care system as a whole, every time we consume $1 in services we pay only 21 cents out of pocket. The remaining 79 cents is paid by a third party (employer, insurance company or government). Yet third-party payers do not reimburse all medical expenses uniformly.

As Figure I shows, on the average patients pay only 4.5 cents out of every dollar they spend on hospitals, but they pay 68 cents of every dollar they spend on pharmaceuticals. Thus, to patients, hospital-based therapies may appear cheaper than drug therapies, even though the opposite is true for society as a whole.

Because the out-of-pocket costs they face do not reflect real costs, patients sometimes choose medical services that deliver less bang for the buck. The choice leans heavily toward those treatments with the lowest out-of-pocket costs, even though they may be more expensive from society's perspective and no more effective than cheaper alternatives.

FIGURE I

Out-of-Pocket Payment of Medical Bills



[1] Includes devices and other medical nondurables.

Government Policies. The federal government encourages such distortions in two ways. First, the tax law subsidizes third-party payment of medical bills through employer-based health plans, while penalizing people who self-insure and pay small medical bills from personal savings. Every dollar an employer spends on health insurance escapes federal, state and local taxes. But if the employer tries to put that same dollar in an employee's Medical Savings Account, the taxes can take as much as 50 cents up front.

Second, government distorts incentives directly when it acts as a third-party payer through such programs as Medicare and Medicaid. Elderly Medicare patients, for example, may choose expensive surgery and in-patient hospital care over drug therapy since Medicare will pay physician and hospital charges but not the cost of drugs.

When indirect tax subsidies are combined with direct spending programs, on the average government spends about 55 cents of every dollar spent on hospital care but only 11 cents of every dollar spent on pharmaceuticals.

The Cost of Third-Party Payment Distortions. Using the National Center for Policy Analysis/Fiscal Associates Health Care Model, Gary Robbins and Aldona Robbins found that if private insurance reimbursed all medical expenses at the same rate, patients and doctors would reduce their spending on hospitals by one-third. By contrast, they would increase spending on nurses and other nonphysician personnel by more than one-third. And they would spend 45 percent more on pharmaceuticals.

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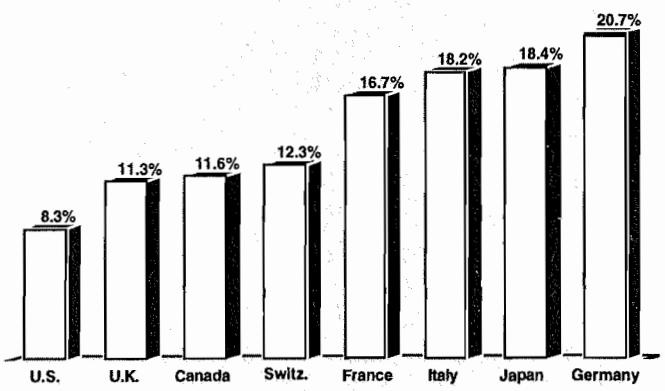
Overall, eliminating the distortions caused by private third-party payments would allow us to reduce total health care spending by 8.5 percent. In current prices, that means we could spend about $85 billion less, without reducing the quality of patient care.

The move to a uniform rate of third-party reimbursement for all types of health services by all public and private insurance *would allow society to produce and consume an additional $155 billion a year in nonhealth goods and services without any reduction in the quality of health care we receive. This change would be worth about $600 per year for every man, woman and child in the country.*

FIGURE II

Drugs as a Percent of Health Spending



Source: George J. Schieber, Jean-Pierre Poullier and Leslie M. Greenwald, "Health Care Systems in Twenty-Four Countries," *Health Affairs*, Fall 1991, pp. 22-38, Exhibits 1,7.

Single-Payer Systems. In many developed countries, health care is free at the point of consumption. These countries' systems do not give people a financial incentive to choose one therapy over another. This may help to explain why such countries spend less on overall health care but use pharmaceuticals more than we do in the United States. On the average, OECD countries spend 37 percent less of their GNPs on health care, and they devote 64 percent more of their health resources to drugs. [See Figure II.] Unfortunately, whatever savings single-payer systems deliver through greater use of drugs are more than offset by the inefficiencies of the health care rationing they induce.

Managed Care. At the time patients consume medical services in a Health Maintenance Organization (HMO), they usually pay little or nothing out of pocket. Since all HMO medical services have a price of zero, patients do not face distorted incentives with respect to the choice of therapies. And because HMO physicians are often rewarded for keeping costs down, other things being equal, they have a positive incentive to choose the least costly therapies. As a result, HMOs tend to rely more frequently on drug therapy than on other types of therapies.

The incentives to hold down costs in HMOs may create perverse results, however. Managed care bureaucracies may prevent patients from obtaining expensive drugs. A recent survey of the physicians participating in TennCare, Tennessee's Medicaid managed care program, found that 93 percent were unable to prescribe a drug because it wasn't on the state's formulary.

Medical Savings Accounts. A number of employers are combining catastrophic insurance with deposits to Medical Savings Accounts (MSAs). Under these plans, employees manage the first $2,000 to $3,000 of their own medical expenses, and they get to keep any MSA money they don't spend on health care. Thus when people use MSAs to pay for health care, they have an economic incentive to weigh a dollar's worth of pharmaceuticals against a dollar's worth of other care. An MSA makes pharmaceuticals more attractive and gives patients a self-interest in eliminating inefficiency and waste.

Greater use of pharmaceuticals could bring down health care costs and make our health care system more efficient. However, the best way to achieve this result is by empowering patients rather than bureaucracies and by avoiding health care rationing.