BRIEF CONTENTS

PART I  Basic Economics Tools  1
Chapter 1  Introduction  2
Chapter 2  Microeconomic Tools for Health Economics  20
Chapter 3  Statistical Tools for Health Economics  48
Chapter 4  Economic Efficiency and Cost-Benefit Analysis  64

PART II  Supply and Demand  85
Chapter 5  Production of Health  86
Chapter 6  The Production, Cost, and Technology of Health Care  105
Chapter 7  Demand for Health Capital  128
Chapter 8  Demand and Supply of Health Insurance  143
Chapter 9  Consumer Choice and Demand  167

PART III  Information and Insurance Markets  189
Chapter 10  Asymmetric Information and Agency  190
Chapter 11  The Organization of Health Insurance Markets  204
Chapter 12  Managed Care  230
Chapter 13  Nonprofit Firms  258

PART IV  Key Players in the Health Care Sector  279
Chapter 14  Hospitals and Long-Term Care  280
Chapter 15  The Physician's Practice  299
Chapter 16  Health Care Labor Markets and Professional Training  317
Chapter 17  The Pharmaceutical Industry  342

PART V  Social Insurance  365
Chapter 18  Equity, Efficiency, and Need  366
Chapter 19  Government Intervention in Health Care Markets  389
Chapter 20  Government Regulation: Principal Regulatory Mechanisms  406
Chapter 21  Social Insurance  436
Chapter 22  Comparative Health Care Systems  467
Chapter 23  Health System Reform  493

PART VI  Special Topics  511
Chapter 24  The Health Economics of Bads  512
Chapter 25  Epidemiology and Economics: HIV/AIDS in Africa  530
Functions and Curves 27
  Linear Functions 27
  Demand Functions 27
  Derived Demand 29
Consumer Theory: Ideas Behind the Demand Curve 29
  Utility 29
  Indifference Curves 30
  Budget Constraints 31
  Consumer Equilibrium 32
Individual and Market Demands 33
Elasticities 34
  Production and Market Supply 35
    The Production Function 36
    Production Functions 37
    Isocost Curves 39
      Cost Minimization or Output Maximization 40
      Marginal and Average Cost Curves 40
The Firm Supply Curve Under Perfect Competition 41
Monopoly and Other Market Structures 43
Welfare Losses 44
Conclusions 46
  Summary 46 • Discussion Questions 47 • Exercises 47

Chapter 3 Statistical Tools for Health Economics 48
Hypothesis Testing 49
  Difference of Means 50
    The Variance of a Distribution 50
    Standard Error of the Mean 51
    Hypothesis and Inferences 52
Regression Analysis 54
  Ordinary Least Squares (OLS) Regressions 55
    A Demand Regression 56
    Eliminating Elasticities 57
Multiple Regression Analysis 58
  Interpreting Regression Coefficients 58
  Dummy Variables 60
Statistical Inference in the Sciences and Social Sciences 61
Conclusions 61
  Summary 61 • Discussion Questions 62 • Exercises 62

Chapter 4 Economic Efficiency and Cost-Benefit Analysis 64
Economic Efficiency 64
Cost-Benefit Analysis: Background 67
Cost-Benefit Analysis: Basic Principles 67
  Measuring Costs 68
Risk Equity Versus Equality of Marginal Costs per Life Saved 68
Marginal Analysis in CBA 69
Discounting 70
Risk Adjustment and CBA 72
Distributional Adjustments 72
Inflation 73
Valuing Human Life 73
Willingness to Pay and Willingness to Accept 73
Contingent Valuation 73
How Valuable Is the Last Year of Life? 74
Cost-Benefit Analyses of Heart Care Treatment 75
Cost-Effectiveness Analysis 76
Advantages of CEA 77
Cost-Utility Analysis, QALYs, and DALYs 77
An ACE Inhibitor Application of Cost-Effectiveness Analysis 78
QALYs Revisited: Praise and Criticism 79
Are QALYs Consistent with Standard Welfare Economics? 79
Extra-Welfarism 79
Sen's Capability Approach and QALYs 79
Linearity Versus What People Think 79
The Ageism Critique of QALYs 80
Conclusions 80
Summary 81 • Discussion Questions 82 • Exercises 82

Part II  Supply and Demand 85

Chapter 5  Production of Health 86
The Production Function of Health 86
The Historical Role of Medicine and Health Care 89
The Rising Population and the Role of Medicine 89
What Caused the Mortality Rate Declines? Was It Medicine? 91
What Lessons Are Learned from the Medical Historian? 93
The Production of Health in the Modern Day 94
Preliminary Issues 95
The Contribution of Health Care to Population Health: The Modern Era 95
Is Health Care Worth It? 96
Issues of Race and Gender 96
Prenatal Care 96
The World's Pharmacies 98
Morbidity Studies 98
How Does Health Care Affect Other Measures of Health? 98
On the Importance of Lifestyle and Environment 99
Cigarettes, Exercise, and a Good Night's Sleep 100
The Family as Producer of Health 100
Social Capital and Health 101
Environmental Pollution 101
Income and Health 102
The Role of Schooling 102
  Two Theories About the Role of Schooling 102
  Empirical Studies on the Role of Schooling in Health 103
Conclusions 103
Summary 103 • Discussion Questions 104 • Exercises 104

Chapter 6 The Production, Cost, and Technology of Health Care 105
Production and the Possibilities for Substitution 106
  Substitution 106
  What Degree of Substitution Is Possible? 107
  Elasticity of Substitution 108
  Estimates for Hospital Care 109
Costs in Theory and Practice 109
  Deriving the Cost Function 109
  Cost Minimization 111
  Economies of Scale and Scope 112
  Why Would Economies of Scale and Scope Be Important? 113
  Empirical Cost-Function Studies 114
  Difficulties Faced by All Hospital Cost Studies 114
  Modern Results 116
  Summary: Empirical Cost Studies and Economies of Scale 116
Technical and Allocative Inefficiency 116
  Technical Inefficiency 116
  Allocative Inefficiency 117
  Frontier Analysis 118
  The Uses of Hospital Efficiency Studies 119
  For-profit Versus Nonprofit Hospitals 120
  Efficiency and Hospital Quality 120
  Performance-Based Budgeting 120
Technological Changes and Costs 121
  Technological Change: Cost Increasing or Decreasing? 121
  Health Care Price Increases When Technological Change Occurs 122
Diffusion of New Health Care Technologies 123
  Who Adopts and Why? 123
  Other Factors That May Affect Adoption Rates 125
  Diffusion of Technology and Managed Care 125
Conclusions 125
Summary 126 • Discussion Questions 126 • Exercises 127
Chapter 7  Demand for Health Capital  128

The Demand for Health  128

The Consumer as Health Producer  128

Time Spent Producing Health  129

Labor–Leisure Trade-Offs  130

Trading Leisure for Wages  131

Preferences Between Leisure and Income  131

The Investment/Consumption Aspects of Health  132

Production of Healthy Days  132

Production of Health and Home Goods  133

Investment over Time  134

The Cost of Capital  134

The Demand for Health Capital  135

Marginal Efficiency of Investment and Rate of Return  135

The Decreasing MEI  135

Changes in Equilibrium: Age, Wage, Education, and Uncertainty  136

Age  136

Wage Rate  137

Education  137

Uncertainty  138

Empirical Analyses Using Grossman's Model  139

Conclusions  140

Summary  141  •  Discussion Questions  141  •  Exercises  142

Chapter 8  Demand and Supply of Health Insurance  143

What Is Insurance?  143

Insurance Versus Social Insurance  144

Insurance Terminology  144

Risk and Insurance  145

Expected Value  145

Marginal Utility of Wealth and Risk Aversion  146

Purchasing Insurance  147

The Demand for Insurance  148

How Much Insurance?  148

Changes in Premiums  150

Changes in Expected Loss  150

Changes in Wealth  151

The Supply of Insurance  151

Competition and Normal Profits  151

The Case of Moral Hazard  154

Demand for Care and Moral Hazard  154

Effects of Coinsurance and Deductibles  156

Health Insurance and the Efficient Allocation of Resources  157

The Impact of Coinsurance  157
Chapter 9 Consumer Choice and Demand 167
Applying the Standard Budget Constraint Model 168
  The Consumer’s Equilibrium 169
  Demand Shifters 170
  Health Status and Demand 172
Two Additional Demand Shifters—Time and Coinsurance 172
  The Role of Time 172
  The Role of Coinsurance 174
Issues in Measuring Health Care Demand 176
  Individual and Market Demand Functions 176
  Measurement and Definitions 177
  Differences in the Study Populations 177
  Data Sources 177
  Experimental and Nonexperimental Data 178
Empirical Measurements of Demand Elasticities 178
  Price Elasticities 178
  Individual Income Elasticities 180
  Income Elasticities Across Countries 180
  Insurance Elasticities 181
Impacts of Insurance on Aggregate Expenditures 183
Other Variables Affecting Demand 183
  Ethnicity and Gender 183
  Urban Versus Rural 184
  Education 184
  Age, Health Status, and Uncertainty 185
Conclusions 185
Summary 186 • Discussion Questions 187 • Exercises 187

Part III Information and Insurance Markets 189

Chapter 10 Asymmetric Information and Agency 190
Overview of Information Issues 191
Asymmetric Information 191
  On the Extent of Information Problems in the Health Sector 191
  Asymmetric Information in the Used-Car Market:
    The Lemons Principle 193
Application of the Lemons Principle: Health Insurance 194
  Inefficiencies of Adverse Selection 195
  Experience Rating and Adverse Selection 196
Chapter 13 Nonprofit Firms 258
An Introduction to Nonprofits 258
Why Nonprofits Exist and Why They Are Prevalent in Health Care 259
Nonprofits as Providers of Unmet Demands for Public Goods 259
The Public Good–Private Good Aspect of Donations 260
Relevance to Health Care Markets 262
Nonprofits as a Response to Contract Failure 262
Applications of Contract Failure to Nursing Home Care 263
Relevance of Contract Failure to Hospitals and Other Firms 263
Financial Matters and the Nonprofit 264
Summary of the Reasons for the Prevalence of Nonprofits 264
Models of Nonprofit Hospital Behavior 264
The Quality–Quantity Nonprofit Theory 264
The Profit-Deviating Nonprofit Hospital 266
The Hospital as a Physicians' Cooperative 267
Maximizing Net Revenue per Physician 268
### Part IV  Key Players in the Health Care Sector  279

#### Chapter 14  Hospitals and Long-Term Care  280
- Background and Overview of Hospitals  280
  - History  281
  - Organization  282
  - Regulation and Accreditation  283
- Hospital Utilization and Costs  283
  - Competition and Costs  284
- Closures, Mergers, and Restructuring  288
- Quality of Care  290
- Nursing Homes  291
  - Background and Costs  291
  - Quality of Care  291
  - Excess Demand  292
  - Financing Long-Term Care  294
- Hospice, Home Health, and Informal Care  295
- Conclusions  296
  - Summary  297 • Discussion Questions  297 • Exercises  298

#### Chapter 15  The Physician’s Practice  299
- A Benchmark Model of the Physician’s Practice  300
- Do Physicians Respond to Financial Incentives?  302
- Physician Agency and Supplier-Induced Demand  302
  - Modeling Supplier-Induced Demand  303
  - The Target Income Hypothesis  303
  - The Benchmark Model as a Synthesis  305
  - The Parallel Between Inducement and Marketing  306
- What Do the Data Say About Supplier-Induced Demand?  306
- Physician Fees, Fee Tests, and Fee Controls  307
- Diffusion of Information and Small Area Variations  308
  - Contributions to These Variations  309
  - The Physician Practice Style Hypothesis  309
### Contents

- Multiple Regression Approaches 310
- SAV and the Social Cost of Inappropriate Utilization 311
- Other SAV Applications 312
- Other Physician Issues and Policy Puzzles 312
  - Physician Pricing and Price Discrimination 312
  - Paying for Outcomes 314
- Conclusions 314
- **Summary** 315 • **Discussion Questions** 315 • **Exercises** 316

### Chapter 16 Health Care Labor Markets and Professional Training 317

- The Demand for and Supply of Health Care Labor 317
  - Production Functions and Isoquants 318
  - Marginal Productivity of Labor 319
  - Factor Substitution and Labor Demand 320
  - The Supply of Labor 320
- Factor Productivity and Substitution Among Factors 322
  - Measurement of Physician Productivity 322
- The Efficient Utilization of Physician Assistants: Substitution Among Inputs 322
- Health Manpower Availability and the Meaning of Shortages 323
  - Availability of Physicians 324
  - Economic Definitions of Shortages of Health Professionals 325
- The Role of Monopsony Power: Shortages of Registered Nurses 328
- Medical Education Issues and the Question of Control 330
  - Sources of Medical School Revenues 330
  - Capital Market Imperfections Justify Subsidies 330
  - Teaching Hospitals, Medical Schools, and Joint Production 331
- Foreign Medical School Graduates 332
- The Control of Medical Education 332
- Control over Entry 333
  - Another View: The Donor Preference Hypothesis 334
- Licensure and Monopoly Rents 334
  - Public Interest or Self-Interest 335
  - Licensure and Quality 336
- Other Physician Labor Issues 337
  - Specialization 338
  - Physician Income by Gender 338
- Conclusions 339
  - **Summary** 340 • **Discussion Questions** 341 • **Exercises** 341

### Chapter 17 The Pharmaceutical Industry 342

- Structure and Regulation 344
  - Competition 344
  - Barriers to Entry 345
  - Regulation 346
The Production of Health and Substitutability 348
  Least-Cost Production 349
  Insurance and Substitutability 350
  Technological Change 350
Drug Pricing and Profits 352
  Monopoly Pricing 352
  Price Discrimination 353
  Monopsony Pricing and Price Controls 354
  Competition and Generic Entry 355
R&D and Innovation 355
  Investment Decisions 356
  R&D Spending 357
  Firm Size and Innovation 358
  Prices, Price Regulation, and Innovation 358
Cost Containment 359
  Copayments 360
  Generic Substitutes 361
  Drug Formularies 361
Conclusions 362
  Summary 363 • Discussion Questions 363 • Exercises 364

Part V Social Insurance 365

Chapter 18 Equity, Efficiency, and Need 366
  Efficiency and Competitive Markets 367
    The Concept of Pareto Efficiency (Optimality) 367
    Trading Along the Budget Line 368
    The Competitive Equilibrium 369
    The First Fundamental Theorem of Welfare Economics 369
    Redistribution of the Endowment 370
    Price Discrimination 371
    Trade-offs Between Equity and Efficiency 371
  Deviations from the Competitive Model in the Health Care Sector 372
    The Assumptions Under Perfect Competition 372
  Promoting Competition in the Health Care Sector 373
    The Theorem of the Second Best 373
  An Economic Efficiency Rationale for Social Health Insurance 374
  Need and Need-Based Distributions 375
    Health Care Needs and the Social Welfare Function 376
    Norman Daniels's Concept of Health Care Need 380
    Economic Criticisms of Need-Based Distributions 381
  Horizontal Equity and Need 381
Theories of Social Justice 384  
Utilitarianism 384  
Rawls and Justice as Fairness 384  
Liberalism, Classical and Modern 385  
Conclusions 386  
  Summary 387 • Discussion Questions 387 • Exercises 388

Chapter 19  Government Intervention in Health Care Markets 389  
Economic Rationale for Government Intervention 389  
  Monopoly Power 390  
  Public Goods 391  
  Externalities 393  
  Other Rationales for Government Intervention 393  
Forms of Government Intervention 394  
  Commodity Taxes and Subsidies 394  
  Public Provision 395  
  Transfer Programs 395  
  Regulation 396  
Government Involvement in Health Care Markets 396  
  Support of Hospitals 397  
  The Hill-Burton Act 397  
  The Veterans Administration and CHAMPUS 397  
  Food and Drug Administration 398  
  Mandated Health Insurance Benefits 398  
  Tax Policy 398  
  Public Health 398  
  Other Government Programs 399  
Government Failure 399  
  Who Does the Regulator Represent? 401  
  Bureaucracy and Efficiency 402  
Conclusions 404  
  Summary 404 • Discussion Questions 405 • Exercises 405

Chapter 20  Government Regulation: Principal Regulatory Mechanisms 406  
Do the Laws of Supply and Demand Apply? 406  
Objectives of Regulation 408  
  Regulatory Policy 408  
  Regulatory Instruments in Health Care 408  
Regulation of the Hospital Sector 409  
  Empirical Findings on Regulation 409  
Prospective Payment 413  
  Description of PPS 413
<table>
<thead>
<tr>
<th>Chapter 21 Social Insurance</th>
<th>436</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social Insurance and Social Programs</td>
<td>436</td>
</tr>
<tr>
<td>Program Features</td>
<td>437</td>
</tr>
<tr>
<td>Historical Roots of Social Insurance</td>
<td>438</td>
</tr>
<tr>
<td>European Beginnings</td>
<td>438</td>
</tr>
<tr>
<td>Early Experience in the United States</td>
<td>439</td>
</tr>
<tr>
<td>The Establishment of Medicare and Medicaid</td>
<td>439</td>
</tr>
<tr>
<td>Medicare and Medicaid in the United States</td>
<td>441</td>
</tr>
<tr>
<td>Medicare</td>
<td>441</td>
</tr>
<tr>
<td>Part D Prescription Drug Insurance</td>
<td>442</td>
</tr>
<tr>
<td>Medicaid</td>
<td>445</td>
</tr>
<tr>
<td>Medicaid Eligibility</td>
<td>446</td>
</tr>
<tr>
<td>The Medicaid-Medicare Relationship</td>
<td>449</td>
</tr>
<tr>
<td>Medicare and Medicaid: Conflicting Incentives for Long-Term Care</td>
<td>449</td>
</tr>
<tr>
<td>State Children's Health Insurance Program</td>
<td>450</td>
</tr>
<tr>
<td>Public Insurance and Health</td>
<td>451</td>
</tr>
<tr>
<td>The Effects of Medicare and Medicaid</td>
<td>454</td>
</tr>
<tr>
<td>Costs and Inflation</td>
<td>454</td>
</tr>
<tr>
<td>Health Status</td>
<td>459</td>
</tr>
<tr>
<td>Medicare: Recent Changes and Future Prospects</td>
<td>459</td>
</tr>
<tr>
<td>Criticisms of the U.S. Health Care System</td>
<td>462</td>
</tr>
<tr>
<td>Conclusions</td>
<td>464</td>
</tr>
</tbody>
</table>

**Summary** 465 * Discussion Questions 465 * Exercises 465

<table>
<thead>
<tr>
<th>Chapter 22 Comparative Health Care Systems</th>
<th>467</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contemporary Health Care Systems</td>
<td>467</td>
</tr>
<tr>
<td>A Typology of Contemporary Health Care Systems</td>
<td>467</td>
</tr>
</tbody>
</table>