Countervailing Market Power

Statement of the American Medical Association

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Overview

- A “next-best” solution to a dilemma
- Profit maximizing health insurers described
- Countervailing power issues
- Why increased prices won’t be passed on to consumers

The Setting

- Health insurer with market power as a given: a monopolist and a monopsonist
  - The starting point for this discussion
  - Major premise already explored in prior sessions
  - If markets are competitive we don't need to address these questions
  - This is not the forum to reargue competition in health insurance markets

The Dilemma

- Perfect competition would be best
  - Many small buyers and sellers
  - Would need major restructuring of health insurance industry
- Short of a restructuring – what do we do?
- Countervailing power - a “next best” option
- Better than price and quantity regulation

The Profit Maximizing Health Insurer

- Deals with quantity question: How much to produce?
  - Considers employers-demand for health insurance
  - Considers physicians and hospitals-supply of medical care
- Sets price for insurance and wage rates for medical care to obtain a set quantity
- Is a price maker in the health insurance market and in the medical care market

The Insurer (short form)

- Max $\Pi(Q) = P(Q)*Q - W(Q)*Q$
  - Π = profit function
  - P = price of health insurance
  - Q = quantity of medical care & health insurance (simplifies one unit of medical care = one unit of insurance)
  - W = physician wage

The Insurer’s “solution”

- $dP/dQ*Q + P - dW/dQ * Q - W = 0$

- $Q=(P - W) / (dW/dQ - dP/dQ)$
  - Markup P-W
  - Supply curve slope $dW/dQ > 0$
    - Employers’ alternatives
  - Demand curve slope $(- dP/dQ) > 0$
    - Physicians’ alternatives
  - Less elastic curves = more market power

Example

- P=300 W=100
- dW/dQ = 3 and dP/dQ = -3
  - Relatively inelastic curves
- Q = 200/6 or 33.3 units

The Insurer’s Solution

- Responsiveness of demand
  - Market power ≈ relatively inelastic demand
- Responsiveness of supply
  - Market power ≈ relatively inelastic supply
  - Casts doubt on an “all or nothing” supply curve lying below a classic supply curve

Giving Countervailing Power to Physicians

- Physicians have no current ability to exercise countervailing power (absent “integration”)
- Countervailing power gives a more level playing field
- It provides a more elastic supply curve
- It gives welfare increases
  - Quantity rises & wage rate increases improving producer surplus
  - Improved consumer surplus from quantity increases
- Employers already have this power

Example Continued

- Giving countervailing power to physicians makes $dW/dQ = 0.4$
- $Q = 200 / 3.4 = 59$ units
- W increases as Q rises
- This increases producer surplus
- Increase in Q increases consumer welfare as well

If We Give Both Physicians and Employers Countervailing Power

- Increases in quantity – and welfare
- Outcomes closer to competitive solution, depending on relative power
- Is market driven
  - Regulator doesn't need to fix price and deal with conduct

Example Concluded

- Q = 200 / 0.8 = 250 units

- Quantity increase
- Approaches competitive levels of output and price

The Fallacy of the Wage Increase Pass-Through

- Presumes monopolist / monopsonist is passing along physicians price reductions
  - Would be inefficient. Possible but rare.
  - This firm would have all of the market and no profit
  - Prices would be substantially below those in other markets
- A profit-maximizing monopolist is already charging what the market will bear: cannot pass along increased wage rates – will come out of monopoly rents

The Worst Outcome

- The regulator fails to deal with a monopolist / monopsonist health insurer
- The regulator enforces the antitrust laws strictly against employer or physician coalitions
- The result is “one-sided”
- Preserves the health insurer’s market power
- Allows market distortions to continue
- Stands the philosophy of antitrust law on its head

Conclusion

- When a health insurer has monopoly and monopsony power, restoring competition would be the ideal solution
- Failing that, remedies include:
  - Countervailing power
  - Price and conduct regulation
  - Other regulation
- Countervailing power - is a next best remedy
- This could be done by legislation or regulation