

# Addressing Market Failure in the Hospital Market

Examples of how the regulatory methods of the HSCRC were developed to address market failures in the market for hospital services

Regulatory Approach or Method	Market Deficiency Addressed	How Method is more Consistent with a Functioning Market
<p><b>1) Timely and Accurate Data</b> Extensive data collection and public disclosure activities; emphasis on producing timely and accurate data and information that are useful to industry participants.</p>	<p>Helps address current absence of reliable and timely data and information asymmetry issues in the hospital market.</p>	<p>Working markets rely heavily on the availability of timely, accurate and useful data on the product and on relative performance of producers.</p>
<p><b>2) Prospective Payment</b> Establishment of a prospective payment systems that establish predetermined payment levels for a given year.</p>	<p>Addressed problems with "cost-based" reimbursement systems where providers have incentives to increase expenditures in a base year to receive higher payments in future years.</p>	<p>Prospective payment systems contain incentives that more closely resemble the incentives in a competitive market where competition constrains prices during a given year and producers focus on lowering cost.</p>
<p><b>3) Pricing "Accuracy"</b> Establishing prices that reflect costs (uniform markups) and use of fixed payment bundles that accurately reflect relative resource use.</p>	<p>Ability of providers to price-discriminate and "cost-shift" results in large variations in prices for given services and across different providers. Prices bear no relationship to the actual cost to produce the service. Irrational prices send the wrong "signals" to the market.</p>	<p>Markets work best when prices reflect costs and product pricing accurately reflects the relative resource use required to produce different products. Accuracy in pricing results in better allocation of resources.</p>
<p><b>4) Defining Measures of Performance</b> Development of output measures (of relative efficiency and quality) to facilitate hospital-to-hospital comparisons on the basis of relative performance and to link performance to payment mechanisms.</p>	<p>Absence of data, asymmetry of information and complexity of medical practice prevent the development of defined "products" and measures of performance (output measures and outcomes).</p>	<p>Consistent and standardized product definitions allow for a better understanding of what is being purchased and the ability of the market to differentiate providers on the basis of relative performance.</p>
<p><b>5) Uniformity and Standardization</b> Standardization of pricing and application of broad and uniform incentives across all providers and all payers.</p>	<p>Irrational pricing and fragmentation of incentives in the hospital market lead to inconsistent, uncoordinated and counter-productive behavior. Lack of standardization also contributes to higher transaction (administrative) costs.</p>	<p>Competitive markets provide broad and consistent incentives to all producers and consumers to increase efficiency and quality. Standardization of product and pricing aid decision making and reduce transaction costs.</p>
<p><b>6) Incentive-based Payment</b> Linking financial incentives in the payment system to induce desired behavior on the part of providers (establish clear and attainable targets, make the incentives clear and strong and link to specific efficiency and quality targets).</p>	<p>Fragmented, non-standardized and fee-for-service payment results in increased transaction costs, an inability to compare relative performance, and weak or perverse incentives to improve efficiency and quality.</p>	<p>Product standardization and the ability to evaluate relative performance on cost and quality assist "value" driven consumption. Use of financial incentives as a reward for improved efficiency and quality are consistent with the competitive process that reward low cost and high quality producers.</p>
<p><b>7) Cost Control not Profit Control</b> Hospitals are allowed to keep profits earned by performing well relative to established efficiency and quality targets. The ability to retain profits provides strong incentives for hospitals to meet established performance goals.</p>	<p>The lack of effective and clear incentives in the existing hospital market results in virtually unlimited increases in cost and creates profit opportunities that result in excess production relative to what is needed or can be afforded.</p>	<p>Profits in a competitive market are a reward for meeting the needs (low cost and high quality) of consumers and provide a strong incentives to induce effective and efficient operation.</p>
<p><b>8) Ability to Evolve and Experiment</b> Flexible and broad statutory and regulatory language allows for responsive policy development and the ability to innovate and evolve payment systems over time.</p>	<p>Current market dynamics provide few incentives for innovations that reduce cost or improve quality and no mechanism to apply beneficial mechanisms broadly or consistently across the industry.</p>	<p>Competitive markets greatly reward innovation that reduce cost and improve quality and provide broad and consistent incentives for all producers to respond in this fashion.</p>