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Markets as Social Actors

By Peter J. Hammer

The following essay is excerpted from "Arrow's Analysis of Social Institutions: Entering the Marketplace with Giving Hands?" and appears with permission of the publisher. The article appears in the special issue of the Journal of Health Politics, Policy and Law *(October 2001) that uses Kenneth J. Arrow's groundbreaking article "Uncertainty and the Welfare Economics of Medical Care" (53* The American Economic Review *941-973 [December 1963]) — published two years before passage of Medicare and Medicaid — as the springboard for examining economic, market, institutional, and other changes in U.S. healthcare over the past 40 years. Arrow's article "transformed the nascent discipline of health economics into a serious and respected field of economic inquiry," explains Assistant Professor of Law Peter J. Hammer, '89, who co-edited the collection with Deborah Haas-Wilson of Smith College and William M. Sage of Columbia University Law School as part of their research as winners of Robert Wood Johnson Foundation Investigators Awards in Health Policy.*

They explain:

"For medicine, 1963 was a time of hope and optimism, though most of the profession's accomplishments still lay in the future. Most physicians were in solo practice, and many still made house calls. Medical science had made tremendous strides in antiseptic surgery, antibiotics for the treatment of infections, and vaccines for the prevention of diseases such as polio, but few specific therapies for important diseases yet existed. The delivery of professional services was undoubtedly a market transaction, but medical charity was also common, by necessity if not by design. Private health coverage was not yet widespread, and although national health insurance came periodically into political debate, the government still played little direct role in the purchase of medical services. Aggregate national spending on healthcare amounted to roughly 5 percent of the gross domestic product, a substantial but hardly a daunting sum.

"Some 40 years later, healthcare occupies a far more central role in the national economy. Today, it is common to speak of a 'medical care industry' comprising large physician organizations and hospital networks and of using 'competitive forces' to discipline healthcare spending. But even as economics and competition have gained ascendance, we are wrestling with many of the same questions that Arrow attempted to address: What is the proper role of markets in delivering healthcare services?

Can we base our healthcare system exclusively on private competition? What place should be reserved for government or for social mechanisms such as professionalism, nonprofit status, or trust? Do these 'non-market institutions' help markets overcome uncertainty, or do they replace markets that have failed because of informational asymmetry? How does one define the proper boundary between market and non-market institutions?"

By Peter J. Hammer

Frame 10: "Entering the Marketplace with Giving Hands"
You go to the marketplace barefoot, unadorned
Smeared with mud, covered with dust, smiling.
Using no supernatural power
You bring the withered trees to bloom.
The Ox-Herding Pictures
(trans. In Levering and Stryk 2000)

The apparent inconsistency between "giving hands" and behavior normally expected in the marketplace is suggestive of the tensions underlying Arrow's effort to establish an economic role for social institutions. At times, Arrow's analysis appears to be equal parts economics and mysticism:

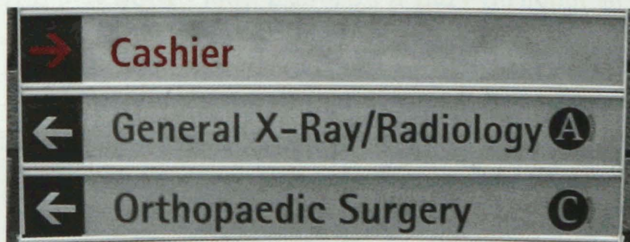
- "I propose here the view that, when the market fails to achieve an optimum state, society will, to some extent at least, recognize the gap, and non-market social institutions will arise attempting to bridge it."
- "I am arguing here that in some circumstances other social institutions will step into the optimality gap, and that the medical-care industry, with its variety of special institutions, some ancient, some modern, exemplifies this tendency."

In *The Ox-Herding Pictures*, a 12th century series of 10 images and poems that illustrate the Buddhist path to enlightenment, the seeker is able to enter the marketplace with giving hands in the tenth and final frame of the story only after a long and arduous journey. The seeker must first search for, capture, tame, and train the ox, where the ox and ox-herding are Buddhist metaphors for gaining control over one's own mind.

One should expect unvarnished social institutions to be at least as stubborn as the untrained ox. Social institutions may well be able to serve Arrow's ultimate economic role, but such giving hands cannot be taken for granted. Such an outcome is more likely to be the result of a process of careful planning and constant struggle. Moreover, in taming the ox, the ox-herder is also changed, raising questions about the effects that Arrow's efforts to rationalize a role for social institutions may have on our understanding of economics itself.

If one acknowledges that in various ways markets are also social institutions, yet another level of complexity must be layered onto the discussion. Economists may respond that of course markets are institutions and of course such institutions are embedded in a deeper social context, but that such embeddedness is sufficiently entrenched to treat the existence of markets and their boundaries as exogenous for purposes of economic analysis. In many settings, like certain commodities markets, this may be a sufficient reply. In healthcare, however, the role and scope of markets as a means of resource allocation is contestable. The role of markets as opposed to current backlash against managed care illustrates the continued contestability of markets in healthcare.

Conceding the social dimensions of markets does not make all aspects of markets or non-market institutions equally contestable. Oliver E. Williamson ("The New Institutional Economics: Taking Stock, Looking Ahead," 38 *Journal of Economic Literature* 595-613 [September 2000]) presents a useful schematic suggesting different levels of embeddedness of markets and institutions. Norms, traditions, and informal institutions are the most embedded, proceeding next to the formal rules governing the institutional environment (property law, government bureaucracies), to



governance issues determining the play of the game (rules of contract and cooperation), and finally to practices controlling the specific allocation of resources. Within this framework, not all aspects of market and non-market institutions pass directly through the political process. Indeed, the political process itself operates against the backdrop of informal institutions, norms, and customs. Accordingly, analysis of issues such as the role and function of trust in the physician-patient relationship might well proceed quite differently from an analysis of issues such as licensing laws.

Implications for policy analysis. Appreciating the fact that markets are themselves contingent social institutions leads to a number of related insights. Rather than being taken as immutable units, the composition of markets is subject to negotiation and change. Moreover, the lines separating market and non-market institutions are often endogenously determined. Appreciating this endogeneity leads to concerns over possible forms of strategic behavior. Actors meet one

another both in the marketplace and in the political arena. Consequently, sources of political power and economic power are interrelated. This provides an alternative explanation for the perceived rigidity of certain institutions. Rigidity may not simply be an artifact of the transaction costs of change and the misalignment of incentives; it may also be in the political and economic self-interest of constituents who are benefited by such rigidity because it forestalls developments they view as disadvantageous.

Adding a political dimension to the economic analysis provides interesting possibilities as well as complications. Markets are not the only means of aggregating individual preferences and making allocative decisions. Arrow himself acknowledges a legitimate role for government in the face of market failures. Some healthcare problems may be more amenable to political rather than economic decision making. At a minimum, the option of utilizing the political process in lieu of markets provides an additional point of reference for conducting comparative institutional analyses. The decision-making heuristics identified in the discussion of welfare economics are largely applicable to policy-making in this realm as well. One should still be concerned about defining the domain of legitimate justifications for displacing markets with non-market institutions, constructing a functional screen for identifying conduct that is in the public interest, maintaining a sensitivity to notions of dynamic efficiency and the adaptability of non-market institutions, and, finally, hedging against the possible overbreadth of non-market interventions. The primary differences are that in this setting the underlying metric of welfare economics is itself contestable and up for grabs, and an appreciation of the endogenity of the line between markets and non-market institutions heightens the need to be concerned about strategic behavior. Social institutions can be used not only as a means of filling the optimality gap, they can also serve as fortresses from which even the socially productive evolution of markets can be forestalled, if such evolution is contrary to the interests of those controlling prevailing institutional structures.

Contemporary policy relevance of market and non-market institutions

Striking the wrong balance between market and non-market institutions can be costly. Few people would defend the totality of healthcare institutions that existed in 1963 as being consistent with Arrow's optimality-gap-filling conjecture. In antitrust parlance, even if some of the non-market institutions served legitimate economic purposes, many aspects of the professional domination of medical services were not necessary to such ends, nor would many traditional non-market restraints constitute the least restrictive means of pursuing such objectives. Developments since 1963 illustrate some of the dangers of misalignments between markets and non-market institutions interacting over time.

Painting with admittedly broad strokes, the argument is as follows: In the four decades since Arrow's article was written, we have been confronted with studies documenting widespread variations in clinical practices (substantially unrelated to quality of care concerns) and a surprising lack of scientific evidence to justify many routine clinical procedures. The rate of technological innovation, dissemination, and obsolescence in healthcare proceeds at tremendously high levels. Some estimates suggest that technology-driven inflation accounts for a substantial percentage of historic healthcare costs. Studies comparing healthcare expenditures and healthcare outcomes among nations raise serious questions about whether the United States is getting its money's worth for the healthcare dollar. The United States spends far more than most other countries on healthcare, yet U.S. health outcomes lag behind other countries in terms of a number of important health indicators. Each of these factors should give us reason to pause and seriously consider what forces have brought us to this point.

The political process itself operates against the backdrop of informal institutions, norms, and customs. Accordingly, analysis of issues such as the role and function of trust in the physician-patient relationship might well proceed quite differently from an analysis of issues such as licensing laws.

Discussion needs to move beyond a simple market versus non-market distinction, which is often overly simplistic and ordinarily misleading. Comparative analysis of healthcare systems provides concrete insight into the notion of multiple possible equilibria and competing sets of market-non-market institutions. Highly defensible systems can be constructed using combinations of building blocks from each domain. What is more important (and what arguably has been missing from U.S. health policy) is a commitment to intra-system rationality. A fruitful research agenda would be to explore the ways in which a lack of policy consistency, coupled with misalignments between market and non-market institutions (compounded over time), have contributed to many of the healthcare problems we face today. Some of the most important challenges facing healthcare policymakers involve the need to impose greater rationality on patterns of clinical practice and processes of technological innovation.

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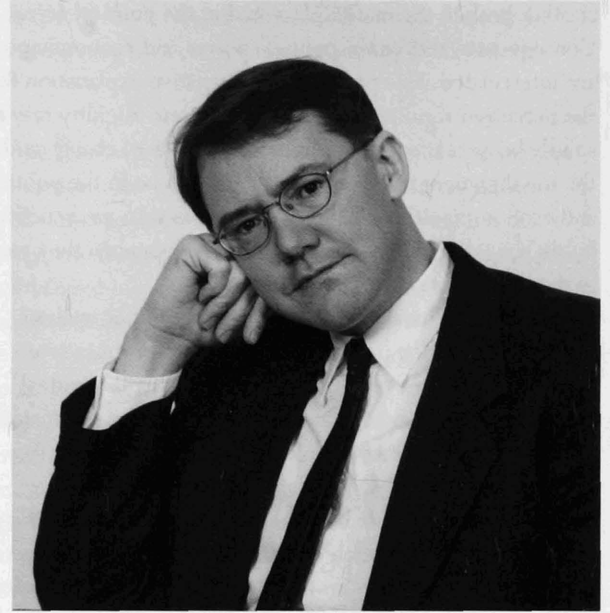
Within Arrow's framework, social institutions and professional norms are instrumentally employed to serve specific economic/policy objectives. They are second-best responses to identifiable market failures. A little reflection on the part of policymakers will often reveal that there are other conceivable market-non-market substitutes that could further similar objectives. We are not necessarily stuck with the non-market institutions that we inherit, nor can we take for granted the fact that social institutions that once served appropriate optimality-gap-filling roles will necessarily evolve over time in ways that continue to serve such functions. From the standpoint of policy-making, there is a need for more vigilance in monitoring the role of non-market institutions and for reassessing the boundaries separating market from non-market institutions over time. Social institutions can provide the market giving hands, but without active oversight there is no guarantee that the efficiency-enhancing role of such institutions will be realized. The ox must still be tamed and trained, and the process of herding never really ends.



An assistant professor at the University of Michigan Law School since 1995, **Peter J. Hammer**, '89, specializes in the study of federal antitrust law and the legal issues surrounding changes in the healthcare industry. Prior to entering academia, Professor Hammer was an associate at the Los Angeles office of O'Melveny & Myers, where he maintained an active practice in antitrust, health law, and the presentation of expert economic testimony. Professor Hammer received his undergraduate education at Gonzaga University and completed his professional and graduate education at the University of Michigan, where he received a J.D. and a Ph.D. (economics). Before entering private practice, he served as a judicial clerk to the Hon. Alfred T. Goodwin, former chief judge of the Ninth Circuit U.S. Court of Appeals.

At the University of Michigan Law School, Professor Hammer founded and directs the Law School's Program for Cambodian Law & Development. The program provides an academic forum for the interdisciplinary study of Cambodian legal institutions and the role of law in the development process. The program's Pro Bono Cambodia Project provides supervised research assistance to groups working in Cambodia, preparing in 1997 a comprehensive election law report and draft national legislation. Professor Hammer has been active in various aspects of law and development, with a particular focus on Cambodia. In 1993, Hammer served on the International Human Rights Law Group's delegation monitoring the UNTAC-sponsored Cambodian elections. From 1993-95, he served as a program advisor to the Cambodian Defenders Project, an initiative designed to train the nation's first public defenders. Since 1996, Professor Hammer has served as a member of the Board of Directors of Legal Aid of Cambodia, a nonprofit, non-governmental organization providing free legal services to Cambodia's poor. From 1997-98, Professor Hammer served as the vice-chair of the International Section of the American Bar Association's Committee on Southeast Asia.