Let’s start discussing the Affordable Care Act by discussing insurance. Most people are risk adverse. If you take someone with $1,000,000 and you offer to flip a coin to have them have $0 or $2 million, most would say no. This means they prefer the certainty of $1 mil. to the risk of 0 or $2 mil. Insurance provides a mechanism to give resources in States with low utility and take it away in states with high utility.

Mass health insurance in the U.S. started with the World War II era (early 1940s). During this time, there were extensive regulation to freeze wage leading employs to offer health insurance as a bonus for keeping workers. Correspondingly the 1940 on saw the development of huge new medical advances, which have extended lifespans but are also very costly. E.g., bypass surgeries, angioplasties, etc for heart disease.

Why are government intervention required? Government has an obligation to maintain the basic human rights.

Starting after WWII, the government here and in other developed counties decided that there is a fundamental right to healthcare. They passed laws forcing hospitals to treat patients and subsidized entry on not-for-profit hospitals that treated the poor for free.

Because of this, the government later decided that it need to force people to have insurance through Medicare and Medicaid as otherwise this burden would fall on the hospitals. However, insurance schemes lead to the problem of adverse selection where healthy people will tend to opt out.

Consider the following example:

Example 1. 50% of people are healthy with
(a) 1% chance of $100,000 medical expenses
(b) 99% chance of $0 medical expenses
50% of people are unhealthy with
(a) 50% chance of $100,000 medical expenses
(b) 50% chance of $0 medical expenses

The expected cost to the insurer would be:
- $50,000 for unhealthy
- $1,000 for healthy or an average of $25,500.

Two things are likely to happen in this market in the example:
(I) If firms have to charge the same for everyone, then healthy people are likely to opt out and not purchase insurance;
(II) Otherwise a private firm will have the incentive to market health insurance at low cost to just the healthy, by using a medical test to screen patients.

The issue with (I) is that the healthy may not get insurance, which is bad if they are risk averse. Moreover, the sick may not be able to afford health insurance and so may not get it either. Scheme (II) solves the problem for the healthy but makes it even worse for the sick.
If we want everyone to get health care, then the bottom line is that we need to subsidize the sick at least somewhat. Moreover, we need to force the healthy to get health insurance or let insurers charge differently for the sick from the healthy. This is why we have a market.

This lead to the three legs of the Affordable Care Act or before that the Massachusetts Healthcare Act on which it was based.

The three legs are:
- Force people and employers to buy health insurance
- Subsidize poor people and sick people to make this affordable
- Set up a marketplace for people to buy insurance.

In Massachusetts, this was called the MA Health Connector. Federally, these are called Health Insurance Exchanges (HIE).

What are HIEs?
Each state will set up a marketplace where individuals can buy standardized health plans. The prices are the same across health status but plans will be reimbursed based on the health status of their patients.

Let’s focus on the visions for healthcare reform offered by both candidates in the recent presidential election.

Gov. Romney had a vision that included letting-
- States make a lot of crucial decisions based on what is right for them.
- Having the marketplace work more efficiently in order to lower prices by providing more information and more consumer payment healthcare through high-deductible plans. Reforming Medicare into a voucher system where beneficiaries could pick from a menu of plans including perhaps traditional medicare- this is similar to Medicare Advantage, which already offers senior the chance to pick a managed care plan.
- To get high-risk people health coverage, he suggested having them be part of a high-risk health insurance pool. Essentially these people would have their coverage subsidized by the government.
- His criticisms of the Affordable Care Act are that:
  * It’s a government takeover of a system that doesn’t work well.
  * It will add a lot of costs because it doesn’t really do anything to control costs and the system needs to.

In his article, Obama mentioned 3 big mechanisms that can lower costs:
- Bundled payments: Means that physicians and hospitals together would receive a single dollar amount for treating a Medicare patient with the same condition. It creates an incentive for the doctor to lower cost by making doctors to negotiate with hospitals.
- Accountable care organizations (ACOs): A way of allowing hospitals and physicians to pocket some of the savings from lowering the treatment cost of patients while maintaining quality.
- Health insurance exchange (HIE): HIW are a marketplace with standardized plans that will allow people to efficiently satisfy the healthcare individual mandate.

Along with more centralized changes like getting rid of Medicare fraud, making billable procedures based on cost-benefit analysis reducing payment for hospital readmissions, etc.