

Competition and Certificate-of-Need Laws

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Revised, August 2023

Abstract

A strong presumption in economics is that competitive markets, with open entry by new firms, is the most beneficial way of economic organization. However, this presumption can be rebutted in particular cases. Certificate-of-need (CON) laws impede entry into many healthcare markets, so would seem to be presumptively harmful. Proponents, though, offer several reasons why this presumption should be rebutted. Economics and healthcare researchers have produced a great deal of evidence to assess these reasons. Overall, their findings do not support the proponents' view. In general, CON does not lower costs, does not increase supply, does not improve quality, and does not increase availability to underserved populations. The presumption of the importance of sustaining competition and open entry are not rebutted.

*This note is an update of a previous commentary that expanded upon an amicus curiae brief the author submitted to the Kentucky Court of Appeals regarding a CON dispute. See *The Christ Hospital Corporation, Inc. (appellant) v. Saint Elizabeth Medical Center, Inc., et. al. (appellees)*, Court of Appeals No. 2018-CA-1096, <https://appellate.kycourts.net/CA/COADockets/CaseDetails.aspx?cn=2018CA001096>. The assessments and views expressed here are entirely my own.

I. Introduction

This policy note offers comment on the importance of competition in market economies and on the impediments certificate-of-need (CON) regulation places on the competitive process. CON regulation prevents supplier/providers from entering certain health care markets unless they can demonstrate to state authorities that there is an unmet need for their services. The issues that arise in CON are of considerable interest to the health policy analysts in particular and to competition policy in general. This policy note presents an overview of the economic issues of CON laws. Section II provides a discussion of why competition is presumptively beneficial to markets and an economy and therefore limits on competition via CON are presumptively harmful. However, this presumption is rebuttal. Section III considers a host of arguments regarding why this presumption ought to be rebutted. None hold up upon careful analysis. Section IV concludes that the presumptions of section II remain in force regarding competition and CON.

II. The Presumptive Benefits of Competition

A. The Basics of Competition

There is a strong presumption in economic analysis that competition is major force to promote the provision of greater quantities and higher quality goods and services to consumers and at lower prices. The basic logic is quite simple: if consumers are not well-served by one supplier/provider, they have the opportunity to turn to others. This is a strong incentive for supplier/providers to serve consumers well. If they consistently fail to do so, most of their customer base and revenue stream is lost. Conversely, providing good service and prices to consumers solidifies the customer base and the financial viability of the organization. Moreover, competitors may enter markets and fill market niches and will do so long as the revenue from the

customer base is sufficient to cover costs. This competitive process squeezes the margin between revenue and cost to the smallest possible amount, implying that the highest feasible value is attained by the consumer. Thus, government regulation of entry into markets of the number and type of suppliers impedes this process and is presumptively harmful to the economy. Certificate of need (CON) programs, which prevent supplier/providers from entering certain health care markets unless state authorities can be convinced that there is an unmet need for their services, fall into the category of presumptively harmful.

B. Legal and Economic Institution that Support Competition

It is noteworthy that the basic incentive effects of competition also work in deeper ways and in conjunction with other institutions.¹ These operate in healthcare markets as well as elsewhere. One such way is through the provider's concern with their reputation. Competition for repeat business from current clients, as well to attract new clients through word-of-mouth and general public impressions, is a further incentive to provide good service to clients. The importance of such reputation-building is heightened by open competition in the marketplace.

Legal institutions also work in tandem with competition, as well as other private sector forces, to enhance consumer welfare. In the context of healthcare, medical malpractice liability is an example. Healthcare providers are legally liable for negligent treatment and possibly for negligence in the selection and supervision of healthcare professionals. This legal liability is another incentive to provide appropriate care to patients. This is reinforced by private malpractice insurance. Malpractice insurance premiums to physicians that are "experience

¹ These are reviewed in Svorny, Shirley, "Medical Licensing: An Obstacle to Affordable, Quality Care," Cato Institute Policy Analysis paper no. 621, September 17, 2008. <https://object.cato.org/sites/cato.org/files/pubs/pdf/pa-621.pdf>.

rated” such that those with a record of many claims are charged a higher premium, thus creating further incentive to avoid negligence.

Hospitals deal with liabilities through self-insurance or by purchasing insurance. Those that buy insurance face a similar situation, i.e., higher premiums are charged to those with a poor record. Hospitals that self-insure directly bear the liability of malpractice claims, thus are incentivized to take due care. As a result, healthcare providers do a great deal of vetting of the credentials of employees, partners, and affiliates, as well as ongoing monitoring of their activities, in order to provide proper care, avoid legal liability, reduce insurance payments, and attract consumers. Also, these activities help serve to meet standards set by private hospital accrediting agencies and by insurers. Moreover, a number of private organizations engage in certification of practitioners (beyond state licensing) and there is a substantial private market that assists healthcare providers in verifying the credentials of potential employees.

In sum, the above practices serve to guard against the loss of reputation, the loss of customers and a revenue stream, and losses due to legal exposure, as well as serving the consumer. Consumers of healthcare are often at an informational disadvantage relative to providers and must rely on them for decisions on treatment. The above practices serve to assist consumers in overcoming this informational disadvantage, and robust competition strengthens this effect. Thus, competition is tremendously valuable to the consumer.

It is important to note that none of these practices require ex ante permission from a government entity to operate in a marketplace, as is the case with CON. Limiting entry into a market is prima facie suspicious as it directly reduces the number of supplier/providers that compete, thus potentially limiting the effectiveness of the above described practices.

Moreover, there are other reasons to doubt the efficacy of government determination of entry. Supplier/providers are well-placed, with their everyday experiences in their market, to assess consumer wishes for more providers or providers of a different type. Competition, along with its companion practices and institutions, incentivizes supplier/providers to form the number and type of establishments that consumers desire. Doing otherwise represents lost business opportunities that one's competitors will embrace. This competitive process determines the number and type of supplier/providers and there is no need for a government bureau to establish these. The legal system plays an important role in the competitive process through liability law and by adjudicating on negligence, damages, and related disputes. But there is no role for government/legal determination of entry into markets.

C. Other Shortcomings of Government Control of Market Entry

Government agencies likely lack both relevant information and the incentives to appropriately determine entry into markets. Such agencies typically do not have the nuanced knowledge of specific markets regarding what is most valued in each setting. Moreover, the regulating agency attains no gain in revenue from good decisions or suffers loss from bad ones. Additionally, significant changes from past agency practices often are met with great pushback regardless of whether the changes are justified. Each of these dulls the incentives for good decision-making. Political influence on the agency, though perhaps indirect, may be substantial.² Incumbent supplier/providers likely have more political sway than potential entrants or consumers and exert influence to maintain the status quo. Indeed, in many states

² The economics and politics of economic regulation and related issues are topics of longstanding investigation by economists. One of the seminal papers is Stigler, George, "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science*, 2(1), Spring 1971. For an overview of related ideas, see Gwartney, James and Wagner, Richard, "The Public Choice Revolution," *The Intercollegiate Review*, 23(2), Spring 1988, <http://sb.cofc.edu/centers/publicchoice/files/Gwartney%20and%20Wagner.pdf>.

CON regulations allow incumbent suppliers to weigh in on whether another provider is “needed” in their market. This gives incumbents outsized influence that serves to limit entry and competition.

Though there is the strong presumption of the benefits of competition, and of the undesirable effects of entry-limiting regulation such as CON, this presumption is rebuttable. There may be special cases where the above analysis does not fully hold. Naturally, it is important to consider if this is the case with CON regulation. Various reasons have been put forth to justify CON. Fortunately, there is a good deal of analysis and empirical study of these claims. We now turn to discussing these.

III. Can the Presumptive Benefits of Competition be Credibly Rebutted?

The National Health Planning and Resources Development Act of 1974 strongly incentivized states to adopt CON laws and by 1980, 49 states had them. In 1986, this federal act was repealed and a number of states began removing their CON regulations. Now, just 35 states (plus Washington, DC) have CON laws, though some states with CON laws have more limited coverage. Thus, there is a good deal of opportunity to compare outcomes in healthcare markets with and without CON. Many analysts have done so. The various arguments supporting CON have been examined and are discussed below.

A. Control of Healthcare Costs

A primary argument originally put forth in favor of CON is that it is necessary to control the rising costs of healthcare due to the overbuilding of hospitals and overinvestment in equipment. In a normal market setting, this does not make sense. Suppliers incur expenses of providing services only if consumers are willing to pay at least the cost of providing those services. Thus, there are strong incentives to avoid overinvestment. However, in the case of

healthcare, many customers are insured and so may not be very sensitive to the cost of care. Additionally, Medicare and other insurers previously used retrospective cost reimbursement to pay providers, i.e., whatever the costs incurred, insurance paid it. This rewards a high volume of treatment and inefficiency, resulting in higher public and private insurance payments. CON was intended to counteract this by requiring greater justification for opening new healthcare facilities. However, insurance has moved away from retrospective payment toward prospective payment, where only a pre-established fee is paid for each medical service. This removes much of the incentive to increase hospital volume.

Nevertheless, the question of cost control has been studied and settled for quite some time. An early summary is in Anderson (1989).³ In reviewing his and others' research, Anderson (1989) finds that there is near total agreement that CON does not restrain per diem, per case, or per capita hospital costs and often increase costs. A later summary (FTC/DOJ, 2016⁴) concludes: "The best empirical evidence suggests that greater competition incentivizes providers to become more efficient" and "the Agencies have found no empirical evidence that CON laws have successfully restricted 'over-investment'" (p. 13).

The ineffectiveness of CON in this regard likely stems from the fact that it does nothing to change any incentive for excessive costs. The fundamental driver in this respect was the now-replaced retrospective cost payment system. CON laws have nothing to do with this.

³ Anderson, Keith, "Certificate of Need Regulation of Health Care Facilities," statement before the North Carolina State Goals and Policy Board, March 1989, https://www.ftc.gov/sites/default/files/documents/advocacy_documents/ftc-staff-comment-north-carolina-state-goals-and-policy-board-concerning-certificate-need-regulation/v890028.pdf.

⁴ Joint Statement of the Federal Trade Commission and the Antitrust Division of the U.S. Department on Certificate-of-Need Laws and South Carolina House Bill 3250, January 2016, https://www.ftc.gov/system/files/documents/advocacy_documents/joint-statement-federal-trade-commission-antitrust-division-u.s.department-justice-certificate-need-laws-south-carolina-house-bill-3250/160111ftc-doj-sclaw.pdf.

B. The Supply and Availability of Healthcare

Another set of arguments in favor of CON laws is that they are needed to facilitate and coordinate the planning of new services and facilities. Somewhat related to this is the viewpoint that CON is especially critical to assure an adequate amount of healthcare to underserved rural areas and to the uninsured, indigent population. Each of these has to do with enhancing the supply of healthcare services.

(i) Overall Healthcare Supply

Regarding the overall supply of healthcare, this turns the argument of “cost control” on its head. Concerns about cost control suggest that an oversupply of healthcare is a problem. Here, the argument is that undersupply, and inappropriate planning of facility location and type, are the problems. Thus, a government agency is needed to appropriately control the supply.

The evidence on the effect of CON laws on the general availability of healthcare services seems clear: they reduce the overall supply and weaken competition. An overview of material leading to this conclusion is in Botti (2007).⁵ Though there are many studies on this subject, a notable and relatively recent one is Custer, et. al. (2006).⁶ This study finds that states with the strictest CON laws have fewer hospital beds, admissions, and inpatient days as well as fewer physicians per capita. Other recent research finds that states with CON laws have less access to

⁵ Botti, Mark, “Competition in Healthcare and Certificates of Need,” comments before a Joint Session of the Health and Human Services Committee of the State Senate and the CON Special Committee of the State House of Representatives of the General Assembly of Georgia, U.S. Department of Justice, Antitrust Division, February 23, 2007, <https://www.justice.gov/atr/competition-healthcare-and-certificates-need>.

⁶ Custer, W.S. et. al., “Report of Data Analysis to the Georgia Commission on the Efficacy of the CON Program,” GHPS Reports, November 2006, https://scholarworks.gsu.edu/cgi/viewcontent.cgi?article=1017&context=ghpc_reports.

imaging services (i.e., MRI, CT, and PET scanners)⁷ and to ambulance services.⁸ These recent studies reinforce the conclusion that CON laws reduce general access to healthcare.

(ii) Access to the Underserved

As noted above, many analysts have considered the problem of access to care by potentially underserved populations, including certain rural areas and the uninsured and indigent. Healthcare providers might incur the expense of treating the uninsured and underinsured with little or no compensation. Moreover, some providers target this population as part of their mission. Certain Medicaid patients may fall into the category of underinsured since reimbursement rates in this program can be quite low. Rural hospitals often have a disproportionate share of these patients.

One way to enable providers to continue to treat the un- or underinsured is to facilitate their attainment of excess profit from one group of customers, with that excess available to fund the charity care cases. This is termed cross-subsidization. With this rationale for CON, then its goal must be to restrict competition and enable higher profits from paying customers. If CON regulators do not do this, the concern is that new entrants will serve only the high-profit clients, leaving the charity cases for incumbents. The latter cannot stay in business by serving predominantly charity cases. This argument for CON comes with the presumption that incumbents continue to provide charity care and that entrants avoid doing so.

⁷ Stratmann, Thomas and Baker, Matthew, “Barriers to Entry in the Healthcare Markets,” Mercatus Working Paper, 2017, <https://www.mercatus.org/system/files/stratmann-barriers-to-entry-con-wp-mercatus-v1.pdf>.

⁸ Harris, Jordan and Kolyaskina, Dasha, “Certificate of Need: Kentucky’s CON Regulations and Their Impact on Ambulance Care,” Pegasus Institute, July 2018, https://docs.wixstatic.com/ugd/7b8e16_dacd5e238e9a42749a4efa58312567c8.pdf.

Empirical analysis of this issue suggests that it is not an overarching problem. Though there is evidence of cross-subsidization,⁹ the question is how large of a burden it is and whether CON is needed to sustain it. Recent empirical studies have examined whether the uninsured and indigent attain more care in CON states. Custer, et. al. (2006) study find no clear pattern in this regard.¹⁰ Stratmann and Russ (2014) find that CON is associated with less competition and less availability of medical services, as found in other studies, but it is not associated with more uncompensated care or a higher percentage of Medicaid patients.¹¹ In a related vein, Stratmann and Koopman (2016) focus specifically on hospitals and ambulatory surgery centers (ASCs). They examine whether CON laws have enabled more rural hospitals and rural ASCs to survive, as well as the effect on the total number in the state.¹² They find that CON regulation is related to fewer total hospitals and ASCs, as well as fewer rural hospitals and ASCs. In sum, it is apparent that in non-CON states, new entrants are not disproportionately siphoning off paying customers from incumbent providers, thereby limiting care for the indigent or un- and underinsured. Indeed, FTC/DOJ (2016) concludes: “Although advocates of CON laws might seek to promote indigent care, the evidence does not show that CON laws advance that goal” (p. 16).¹³

⁹ See chapter 3 of Federal Trade Commission and Department of Justice, *Improving Health Care: A Dose of Competition*, FTC and DOJ, July 2004, <https://www.ftc.gov/sites/default/files/documents/reports/improving-health-care-dose-competition-report-federal-trade-commission-and-department-justice/040723healthcarerpt.pdf>.

¹⁰ Supra note 6.

¹¹ Stratmann, Thomas and Russ, Jacob, “Do Certificate-of-Need Laws Increase Indigent Care?,” Mercatus Center Working Paper No. 14-20, July 2014, <https://www.mercatus.org/system/files/Stratmann-Certificate-of-Need.pdf>.

¹² Stratmann, Thomas and Koopman, Christopher, “Entry Regulation and Rural Health Care,” Mercatus Working Paper, February 2016, <https://www.mercatus.org/system/files/Stratmann-Rural-Health-Care-v1.pdf>.

¹³ Supra note 4.

C. Quality Assurance

Another reason put forth in support of CON laws is that they are needed to assure a high quality of care. Healthcare services, it is argued, is a special market where consumers have little knowledge of appropriate treatments and are especially reliant on providers in this regard. This raises the concern that consumers may be misled into undergoing unneeded procedures and tests. Thus, CON is needed to help protect consumer from low-quality and deceitful providers. It is true that consumers often are at an information disadvantage when dealing with a healthcare provider. However, as noted above, competitive markets are supported by a host of practices and institutions that assist consumers in this regard. The question is whether limitations on entry as implemented by CON regulation would add to the quality assurance mechanisms already in place. This is possible if CON, by increasing volume per hospital, can improve quality. It is also possible that CON induces lower quality. Since CON reduces the number of providers in markets, this may ease the competitive pressure to maintain high quality standards.

The idea that CON has served to improve the quality of healthcare services has been examined empirically. In their review of the research, Stratmann and Wille (2016) indicate that nearly all studies of the quality of care find it to be the same or worse in states with CON regulation.¹⁴ Stratmann and Wille's (2016) own research reinforces this. They compare measures of quality (e.g., rehospitalization and readmission rates, mortality rates, patient surveys) for hospitals in the same metropolitan area but in different states, one with a CON law and the other without. With some quality measures, there is no difference in quality of care

¹⁴ Stratmann, Thomas and Wille, David, "Certificate-of-Need Laws and Hospital Quality," Mercatus Working Paper, September 2016, <https://www.mercatus.org/system/files/mercatus-stratmann-wille-con-hospital-quality-v1.pdf>.

between CON and non-CON states. But with others, quality is lower in CON markets and they find no measure where CON states have higher quality. In another recent study, Choudhury, et. al. (2022) find lower mortality rates in states that loosened their CON laws during COVID-19.¹⁵ To quote FTC/DOJ (2016) again: “The weight of this research has found that repealing or narrowing CON laws is generally unlikely to lower quality, and may, in fact, improve the quality of certain types of care” (p. 15).¹⁶

D. It's Not a Free Market

Healthcare markets are certainly not textbook examples of free and perfectly competitive markets. There is the ongoing issue of the lack of knowledge by consumers relative to providers that, even though addressed by a host of practices, can still be problematic. Government policy may be able to help consumers address this problem through, for example, transparent pricing guidelines and improved tort law. However, CON law simply do not address this.

Also, government-provided and third-party insurance can lead to uneconomic decision-making by consumers. This, too, cannot be effectively addressed by CON laws. Additionally, healthcare provides must deal with a host of federal and state regulation, as well as constraints from insurers. CON provides no obvious way of improving how other regulatory constraints are handled.

¹⁵ Choudhury, A., Ghosh, S., and Plemmons, A., “Certificate of Need Laws and Health Care Use during the COVID-19 Pandemic,” *Journal of Risk and Financial Management*, 15(2), 2022, <https://doi.org/10.3390/jrfm15020076>.

¹⁶ *Supra* note 4.

IV. Conclusion

Another excellent summary of the research on CON is in Cavanaugh and Mitchell (2023).¹⁷ Their findings are consistent with those here. In practice, CON laws generally have served to reduce competition and consumer choice without any of their alleged benefits. Strengthening competition and removing regulatory barriers to entry are the presumptive policy prescriptions for markets. None of the arguments for rebuttal of these presumptions regarding CON laws are found to be valid. The presumption stands.

¹⁷ Cavanaugh, Jaimie and Matthew D. Mitchell, *Striving for Better Care: A Review of Kentucky's Certificate of Need Laws*, Institute for Justice, August 2023, <https://ij.org/report/striving-for-better-care/applying-for-a-certificate-of-need/>.