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Competitive Pricing for *All* Medicare Health Plans

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Medicare should use competitive pricing to set the government contribution to the traditional fee-for-service (FFS) Medicare plan and private Medicare Advantage (MA) plans. A competitive pricing system that used the lowest bid from any qualified plan to set the government contribution to all plans would save 8 percent of Medicare costs. A demonstration of competitive pricing is not necessary because we know that this method is administratively practical and that it would save money.

Medicare should be an entitlement to a set of benefits, not to a particular way of financing or delivering those benefits. However, under the current structure of the program, federal payments for Medicare-covered services differ depending on whether the beneficiary is enrolled in the FFS Medicare plan or through private MA health plans. This arrangement creates inefficiency and raises Medicare costs unnecessarily.

There is a solution: full competitive pricing that applies equally to FFS Medicare and MA plans. Our proposal should not be confused with earlier competitive bidding efforts, which were confined to private health plans in Medicare. The more limited approach was proposed in the late 1990s, and preparations were made to test it through demonstration projects in four cities, but Congress blocked those projects in response to concerns from the health plans that would have been affected.[1] The plans were not inclined to bid down their Medicare payments unless all plans—including the FFS Medicare plan—were included in the process.

The time has come for competitive pricing. Growing cost pressures in Medicare demand that we find a more effective pricing mechanism that

Key points in this *Outlook*:

- Premiums for the fee-for-service (FFS) Medicare and private Medicare Advantage (MA) plans vary by market area in ways that do not reflect underlying costs, meaning sometimes the government pays too much to provide health care for beneficiaries. Introducing competitive pricing for all Medicare plans, including the FFS Medicare plan, could save up to 8 percent of Medicare expenditures.

- Applying competitive pricing only to MA plans would substantially reduce potential savings and lead to continued overpayments in some areas.

- Competitive pricing in Medicare can start now and does not require a demonstration because the method is administratively practical and will save money.

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can reduce program outlays without creating artificial supply restrictions that can make it difficult for beneficiaries to access needed care. Competitive pricing is no longer a new idea, and it has been successfully implemented—even in the Medicare program itself.

Medicare covers health care services under a complex financing scheme commonly referenced by the relevant sections of the Social Security Act. Those benefits include:

Part A, which covers inpatient hospital benefits, skilled nursing, home health, and hospice care. Part A is funded primarily through a tax on earnings and operates through the Hospital Insurance Trust Fund.

Part B, which covers physician, outpatient, home health, and preventive services. Part B is funded by general revenues and beneficiary premiums and operates (along with Part D) through the Supplementary Medical Insurance Trust Fund.

Part C, which covers the benefits provided in both Parts A and B, but through private MA plans. MA plans receive a fixed payment per beneficiary from the government to provide Part A and Part B benefits.

Part D, which covers outpatient prescription drugs. Part D is funded by general revenues, beneficiary premiums, and state payments.

All beneficiaries are guaranteed a benefit package—the Medicare "entitlement"—that is specified in Parts A, B, and D. Beneficiaries may receive this package by enrolling in either the traditional FFS Medicare plan or in Part C, which enables them to choose a private MA plan. The cost of providing the entitlement benefit package varies among health plans (both public and private) and from one area of the country to another. In some parts of the country, traditional FFS Medicare is the lowest cost health plan. In other parts of the country, MA plans are the lowest cost alternatives.

Medicare faces a fiscal crisis. The 2009 annual report of the Medicare trustees warns that the Medicare hospital insurance trust fund will pay out more benefits than it receives in revenues by 2017,[2] making it crucial that the government pay only the cost of providing the Medicare entitlement benefit package from the most economical health plan in each market area. The way to do that is to have all health plans—both FFS Medicare and MA plans—submit bids for the entitlement benefit package, and then set the government's contribution to premiums equal to the lowest bid in each market area. There is nothing particularly novel about this proposal. Many employers nationwide have used similar competitive bidding systems to induce competition among the health plans that are offered to their employees.

Two Systems for Providing Medicare Benefits

For beneficiaries in the FFS Medicare plan, the government pays qualified providers—hospitals, physicians, and others—a fee for each medically necessary service covered by the Medicare entitlement. FFS Medicare beneficiaries pay the Part B premium plus applicable copayments and deductibles set by Medicare. About 80 percent of beneficiaries are in the FFS Medicare plan. If beneficiaries in FFS Medicare want additional coverage, they purchase a supplementary, or Medigap, insurance policy and pay the premium out of their own pockets. (There are many different programs that offer assistance to low-income beneficiaries.) Beneficiaries in FFS Medicare who want coverage for outpatient drugs must enroll separately in a private drug plan under Part D.

Beneficiaries also have the option of receiving care from a private plan. In many areas, MA plans are able to offer additional benefits beyond the entitlement at a lower cost than would be available to beneficiaries who enroll in FFS Medicare and purchase Medigap coverage. If a private MA plan charges a premium higher than the premium for Part B, beneficiaries enrolled in the private plan must pay the difference. The private MA plans usually receive separate payments to cover Part D benefits. About 20 percent of beneficiaries are in private MA plans.

The Case for Competitive Pricing

For decades, Medicare has determined its contributions to the premiums of private plans based roughly on the costs of the FFS Medicare plan. The costs of the FFS Medicare plan depend on pricing formulas established by Congress and the type and volume of covered health services used by Medicare beneficiaries. This approach of tying MA payments to FFS costs, or adjustments to those costs (based on minimum annual updates, urban and rural floors, and other factors), has well-known problems. First, wide variation in FFS cost results in wide variations in payments to private MA plans. MA costs do not vary as widely as FFS costs, because beneficiaries

in market areas with high FFS Medicare costs who enroll in MA plans receive a host of free supplementary benefits, financed by the government, while beneficiaries in areas with low FFS costs frequently pay an out-of-pocket premium for benefits only slightly more generous than the entitlement. There is no policy justification for offering free, government-financed supplementary benefits to beneficiaries in one market area but not another. Congress attempted to address the disparity by paying special subsidies ("floor payments") in some market areas to attract private health plans. Both the original payment system and the subsequent attempts to fix it wasted taxpayers' money because they subsidized health plans—both traditional FFS and private plans—that are relatively inefficient in particular market areas. Competitive pricing for all health plans in Medicare will fix that problem. Second, under the current system, information about the costs of care flows in the wrong direction—from an organization that knows very little about the costs of providing insurance (the federal government) to the organizations that know as much as possible about these costs (private MA plans). This virtually guarantees misallocation of resources.

Competitive pricing reverses the flow of information. Through a bidding process, MA plans would tell the government how much it costs to care for Medicare beneficiaries. The reward or penalty for bidding low or high would be predictable—beneficiary out-of-pocket premiums—thereby providing an incentive for plans to offer their best price. For competitive pricing to work, it must encompass all Medicare health plans, including the FFS Medicare plan.

The critical distinction between competitive pricing and the current payment system is that competitive pricing links the rewards and penalties to the prices submitted by plans, rather than to the level of benefits they provide. In a competitive pricing system, plans would submit bids on the defined benefit for a beneficiary of average risk (a "standardized beneficiary," adjusting for differences in age, health status, and other characteristics that affect the use of services). MA plans do this now. The FFS "bid" would be based on average FFS costs for the same type of standardized beneficiary in the bidding area. The government would use those bids to determine the benchmark payment rate (the government's contribution to premiums) for all Medicare plans, including FFS Medicare. Currently, MA bids are not used to set the benchmark.

Our preferred form of competitive pricing would set the government's premium contribution at the lowest bid, subject to the lowest bidder having enough capacity to handle expected enrollment. Beneficiaries who wanted to join a more expensive health plan—including the FFS Medicare plan—would have to pay the additional cost out of their own pockets. The government's premium contribution could be set at the median or average bid, but such an approach would reduce competitive pressures and reduce the savings from competitive pricing.

The Obama administration has proposed a bidding process that recognizes the advantages of competitive pricing, but the administration's proposal has a fundamental flaw: it excludes the FFS Medicare plan from the bidding process.

The reward for low bidders would be increased enrollment. The penalty for high bidders would be lower enrollment as a result of having to charge an additional premium, making them less attractive to beneficiaries than less expensive plans that meet the same quality standards.

The Obama administration has proposed a bidding process that recognizes the advantages of competitive pricing, but the administration's proposal has a fundamental flaw: it excludes the FFS Medicare plan from the bidding process. The proposal is similar to an MA-only competitive bidding design that the Centers for Medicare and Medicaid Services (CMS) unsuccessfully attempted to demonstrate in the 1990s.

There are serious problems with an MA-only bidding arrangement. The inefficiency from excluding the FFS Medicare plan is large. In areas where the FFS Medicare plan is more expensive than private MA plans, beneficiaries who prefer the FFS Medicare plan face no consequences even though their choice costs the Medicare program more money. The reverse is also true: in areas where the FFS Medicare plan is cheaper, beneficiaries who prefer private MA plans will not have to pay the extra cost that their preference imposes on the Medicare program, unless MA payments are capped at FFS Medicare spending levels.

The reasons most often given for excluding the FFS Medicare plan from competitive pricing are political. Beneficiaries in some markets would have to pay more to

stay in the FFS Medicare plan, while others would lose generous supplementary benefits currently offered by private MA plans in areas where these plans are overpaid. However, there are innumerable ways to create a slow transition to full competitive pricing so beneficiaries are not unduly disrupted.[3]

The administration's proposal may be unsatisfying; it will be politically difficult and will not generate sufficient program savings to justify the difficulty. Conversely, our proposal generates substantial savings, and relatively inexpensive steps can ease beneficiaries through a transitional phase.

TABLE 1
SAVINGS FROM COMPETITIVE BIDDING AND OTHER PROPOSALS AS A PERCENTAGE OF TOTAL MEDICARE SPENDING IN 2005

Payment alternative (two through five are bidding models)	Savings as a percentage of total Medicare spending in 2005
1. Pay MA plans at FFS Medicare level (MedPAC)	1%
2. MA-only (Obama administration): benchmark is the average MA bid	2
3. FFS Medicare and MA: benchmark is the average of MA and FFS Medicare bids	1
4. FFS Medicare and MA: benchmark is the lower of the average MA bid and FFS Medicare bid	4
5. FFS Medicare and MA: benchmark is the lowest bid	8

SOURCE: Robert F. Coulam, Roger Feldman, and Bryan E. Dowd, *It's Time to Bring Competitive Prices to Medicare* (Washington, DC: AEI press, forthcoming).

How Much Would Competitive Pricing Save?

Using data from the Medicare Payment Advisory Commission (MedPAC) and the Congressional Budget Office, we have produced static simulations of the savings from five alternative competitive bidding proposals. These alternatives include MedPAC's proposal to pay all plans at the level of FFS Medicare plan costs, the Obama administration's proposal that excludes the FFS Medicare plan from the bidding process, and the more comprehensive bidding models that include the FFS Medicare plan. The savings are estimated as a percentage of total Medicare spending in 2005. See Table 1 for the results of these simulations.

There are three important conclusions to draw from this table:

1. The MedPAC proposal to pay all plans at the FFS Medicare plan level (alternative one) would yield the smallest savings—about 1 percent of total Medicare spending in 2005.

2. Excluding the FFS Medicare plan from the bidding process similarly limits the savings that are possible. The administration's proposal (alternative two) would save only 2 percent of total Medicare spending.

3. Including the FFS Medicare plan in the bidding process may not produce large savings if the benchmark is set too high. Using the average bid to set the benchmark would save 1 percent of Medicare spending (alternative three). A model based on the lower of the FFS Medicare plan bid or the average private MA plan bid does better (alternative four), saving 4 percent of Medicare spending. The alternative that saves the most money by far uses a benchmark to pay both the FFS Medicare plan and private MA plans at the lowest bid from any qualified plan (alternative five). That option yields savings of 8 percent of Medicare spending.

Why a Demonstration Is Not Necessary

The 2003 Medicare Modernization Act requires a demonstration of full competitive pricing beginning in 2010: the so-called Comparative Cost Adjustment Program. There are three reasons why that demonstration is not necessary. First, we know—reliably—that Medicare will save money from competitive pricing. No one seriously doubts that prospect. Every Medicare demonstration of competitive pricing that has reached the point of bids for services has shown substantial savings.[4]

Second, CMS has shown that it can implement a Medicare bidding system expeditiously and effectively without a demonstration. For example, the bidding system for Part D prescription drugs was successfully implemented in two years—attesting to the practicality of competitive pricing when the effort does not face crippling political or legal opposition. Even with opposition, CMS was able to implement two regional demonstrations

of competitive bidding for durable medical equipment (DME) and (for a short time) a DME competitive bidding program in ten cities without notable administrative difficulty. CMS also ran the competitive pricing demonstrations for private health plans in the 1990s without serious problems until the demonstrations were stopped by Congress and the courts.

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Finally, competitive pricing is not a new or untested method. Large public and private employers that offer multiple health plans have been using competitive pricing for years, with favorable results. It has been the norm in state Medicaid programs, DOD-CHAMPUS programs, and the Veterans Administration (for equipment and supplies).

Introducing competitive pricing to Medicare will require careful design and implementation to minimize disruption during the transition. This is a reason to dedicate sufficient time and administrative resources to the project, but not a reason to demand a demonstration.

It should be noted that under our proposal, beneficiaries living in different parts of the country would pay different amounts for the FFS Medicare plan and for private MA plans. Although this may seem objectionable, there is a strong precedent for making some beneficiaries pay more than others for the FFS Medicare plan. By introducing means-tested Part B premiums for high-income beneficiaries in 2007, Congress has already determined that beneficiaries can pay different amounts for the FFS Medicare plan without violating the original intent of Medicare. The current differentiation is based on the beneficiary's income. Our proposal introduces a second differentiation, simply based on whether there is a private MA plan available in the local market that can offer the entitlement package at lower cost than the FFS Medicare plan.

Conclusion

It is time to design a payment system that lets plans tell the government how much it costs to provide the entitlement benefit package to their enrollees—not the other way around—and that subjects the plans to a predictable set of consequences if they submit low or high bids. Saving 8 percent of Medicare's budget will not solve the program's financial problems. But everyone agrees that Medicare must do *something* to control costs, and competitive pricing is a step in the right direction. Of all the payment reform proposals, competitive pricing is the only one that will save a significant amount of money. Competitive pricing will encounter serious political opposition, but the best way to address opposition to needed reforms is not to minimize the extent of the reform, but to recognize reasonable beneficiary needs and expectations. Moreover, competitive pricing could end political bickering over private MA payments and stabilize payment policy for Medicare health plans. With efficient provision of the Medicare entitlement benefits, the focus could be on a better question: what should the entitlement benefits be?

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Notes

1. Bryan E. Dowd, Robert F. Coulam, and Roger Feldman, "A Tale of Four Cities: Medicare Reform and Competitive Pricing," *Health Affairs* 19, no. 5 (September/October 2000): 9–29.
2. Boards of Trustees, *The 2009 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds* (Washington, DC: U.S. Government Printing Office, 2009).
3. Robert F. Coulam, Roger Feldman, and Bryan E. Dowd, *It's Time to Bring Competitive Prices to Medicare* (Washington, DC: AEI Press, forthcoming).
4. Ibid.