The Heritage Foundation

BACKGROUNDER

No. 2878 | FEBRUARY 3, 2014

CBO Confirms: Medicare Premium Support Means Savings for Taxpayers and Seniors

Robert E. Moffit, PhD, and Rea S. Hederman Jr.

Abstract

A major report by the Congressional Budget Office (CBO) confirms that premium support (a defined-contribution system of health-plan financing) would make the financially troubled Medicare program more sustainable. In a new competitive system of health plans, the CBO finds that private health plans can offer the same benefit and services as traditional Medicare fee-for-service plans—at a lower cost to taxpayers. The CBO report also reveals that competition can drive lower beneficiaries' premiums and out-of-pocket costs. The CBO analysis affirms the potential of serious savings for Medicare beneficiaries and taxpayers alike. It also encourages a growing number of analysts who promote premium support as the single best option for comprehensive Medicare reform.

A major report by the Congressional Budget Office (CBO) confirms that Medicare premium support (a defined-contribution system of health-plan financing) would make the financially troubled federal program more fiscally sustainable.[1]

The CBO finds that, in a new competitive system of health plans, private plans can offer the same benefit and services as traditional Medicare fee-for-service (FFS) plans—at a lower cost to taxpayers. Moreover, depending on the competitive bids among plans and the payment structure, the report also reveals that competition can drive lower beneficiaries' premiums and out-of-pocket expenses would decline.

Key Points

- A major report by the Congressional Budget Office (CBO) confirms that Medicare premium support (a defined-contribution system of health-plan financing) would make the financially troubled federal program more fiscally sustainable.
- The CBO finds that, in a new competitive system of health plans, private plans can offer the same benefit and services as traditional Medicare fee-for-service plans—at a lower cost to taxpayers. The report also shows that competition can drive lower beneficiaries' premiums and out-of-pocket expenses would decline.
- The CBO reports that there have "been substantial improvements" in its modeling of insurer and consumer behavior, and its recent analysis of premium support is clearly an improvement over the CBO's earlier scoring of the Medicare reform proposals.
- So far, the CBO has shown that Medicare premium support can yield serious program savings while expanding seniors' options.

This paper, in its entirety, can be found at **http://report.heritage.org/bg2878**

Produced by the Center for Health Policy Studies

The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

Savings for All Taxpayers

There are a variety of ways to structure a Medicare premium support payment system.[2] In its analysis, the CBO modeled two illustrative premium support options and compared its estimates to future Medicare cost projections under current law. The starting date for implementation, under both CBO scenarios, would be 2018, while the CBO projections are for 2020.

The first option would base the federal contribution on the average bid of competing plans and reduce total Medicare spending by $15 billion in 2020. The second option would base the federal plan payment on the second-lowest bid of competing health plans. This approach would reduce total Medicare spending by $45 billion in 2020. In a separate calculation of both options (applied to all Medicare beneficiaries) over the standard 10-year budget period (2014–2023), the CBO estimated that the first option (the average bid option) would reduce net federal spending by $69 billion. The second option (the second-lowest bid option) would reduce that spending by $275 billion.[3] With a full 10-year implementation (2018–2028), of course, the savings would be considerably greater under both options.

Under both options, private insurers and traditional Medicare FFS plans would bid to provide services under Parts A and B. Of the two options, the CBO says that the second would exert greater competitive pressure and therefore would result in greater savings. The CBO also confirms that, since Medicare is a huge component of America's health care economy, "total national spending" would decline under either of these two options.

However, the CBO warns that exempting the baby boomers, or "grandfathering" existing beneficiaries out of the reform initiative, would not generate sufficient savings to help improve Medicare's overall financial condition.[4] If substantial numbers of baby boomers are exempted from premium support in 2020, for example, the savings would be 85 percent less than if all Medicare beneficiaries were allowed to choose among competing plans. In this instance, the change would yield only $8 billion in savings in 2020 under the second-lowest bid option. If every beneficiary were included in the Medicare premium support reform, the savings in 2020 would amount to $45 billion.[5]

Savings for Seniors

Medicare enrollees' personal savings would reflect the payment structure, the region in which they live, and, most important, their personal choices. Under the average bid option, the CBO estimates that beneficiaries' total medical payments (premiums and out-of-pocket costs) in 2020 would decline by about 6 percent, on average, below current law projections. Under the second-lowest bid option, total payments would be about 11 percent higher, on average, compared to current law projections. Enrollees' premiums would be higher on average under the second option, the CBO says, but their out-of-pocket costs would be lower, and these costs make up a larger share of enrollees' total costs than premiums.[6]

Total costs would, of course, reflect significant differences in market conditions and service costs around the country. The CBO assumes that many enrollees would remain in traditional Medicare FFS plans. In certain regions of the country, traditional FFS might mean higher premiums than in competing private plans, and in other regions, traditional FFS might mean lower premiums. Under either premium support option, enrollees would be able to

1. Congressional Budget Office, "A Premium Support System for Medicare: Analysis of Illustrative Options," September 18, 2013, http://www.cbo.gov/publication/44581(accessed January 15, 2014).
2. See, for example, Robert E. Moffit, "The Second Stage of Medicare Reform: Moving to a Premium Support Program," Heritage Foundation *Backgrounder* No. 2626, November 28, 2011, http://report.heritage.org/bg2626.
3. In this instance, the implementation of the premium support would still begin in 2018, representing only six years of savings. Congressional Budget Office, *Options for Reducing the Deficit: 2014 to 2023*, November 2013, p. 204, http://www.cbo.gov/sites/default/files/cbofiles/attachments/44715-OptionsForReducingDeficit-2_1.pdf (accessed January 17, 2014).
4. "Although a grandfather provision would keep current beneficiaries from having to adjust to a premium support system, it would reduce federal savings greatly, because only a small portion of the Medicare population would be covered by the new system initially, and that portion would increase only gradually over many years." Ibid., p. 205.
5. CBO, "A Premium Support System for Medicare," p. 15.
6. Ibid., p. 28.

choose a plan at or below the government payment. Under the second-lowest bid option, the CBO estimates, enrollees' out-of-pocket costs would fall, but that decline might not offset the higher premiums in regions where traditional FFS is expensive.[7]

Meanwhile, the CBO also finds that transforming traditional Medicare FFS into a competing plan would have the overall effect of increasing Medicare savings inasmuch as Medicare rates are lower than private rates, and its competitive role would make the regional bids lower than they would otherwise be. The CBO concludes that, absent traditional Medicare FFS in the pool of competitors, the bids would be higher and thus the beneficiaries and the taxpayers alike would face higher costs.[8]

A Longer View

As noted, for modeling purposes, the CBO focused on a single year—2020—and stipulated that many beneficiaries would choose *not* to switch plans after just one year of higher premium prices. In 2020, for example, the CBO estimates that, under the second-lowest bid option, about 50 percent of all Medicare beneficiaries would remain in traditional FFS, even though the average FFS premium paid by beneficiaries for all regions would amount to $2,500, and average private plan premium payment would amount to $1,800.[9] For the average bid option, the CBO estimates that "slightly more than half" of all beneficiaries would enroll in traditional FFS, and that the average FFS premium plan payment for all regions would be $2,000, while the average private plan premium payment would be $1,000.[10]

It is obvious that in a competitive system, enrollees would have a variety of options in different regions, and that the enrollees' decisions to pay higher premiums, for whatever reason, would be voluntary. Relying on the professional literature on consumer price sensitivity, the CBO notes that enrollees do switch plans when prices rise, but not all at once and sometimes quite slowly.

Nonetheless, we believe, that more and more Medicare beneficiaries would choose less costly and more efficient plans, as time goes by, providing similar or better services than traditional Medicare FFS, with falling premiums. Like other consumers in other markets, seniors can be expected to be price sensitive, particularly in those instances where premium price differentials, as the CBO projects, are significant. Savings to beneficiaries and the program itself would increase because younger and newly enrolled Medicare beneficiaries would not be as attached to older and more expensive traditional Medicare FFS. These younger beneficiaries, many of whom are already attracted to Medicare Advantage plans, would be more likely to enroll in the less-expensive private plans that offer better value for their dollars. This would help control total program costs, and new beneficiaries would pay less than the premium payments in the older Medicare system.

The CBO also assumes that the population in FFS plans will in general be less healthy than those who voluntarily enroll in private health plans. This imbalance could be reduced with better risk-adjustment models (routinely included in virtually all Medicare premium support proposals), where there is no advantage for a plan in having a beneficiary pool that is healthier than average. Beyond that, as private plans offer better benefits, including case management and care coordination, this, too, would encourage greater diversity in the risk pool for both FFS and the newer competing private health plans.

Moving Beyond the Medicare Advantage Model

Medicare premium support is sometimes criticized because the Medicare Advantage (MA) program, also based on competition among health plans, costs taxpayers more than traditional FFS. By law, MA plans cannot offer cash savings to beneficiaries who choose plans that cost less than the government benchmark payment, but they offer richer and thus more expensive benefits. In fact, MA plans offer more benefits and services than traditional Medicare, including protection from the financial devastation of catastrophic illness. While beneficiary enrollment in MA plans reduces reliance on Medicaid and supplemental insurance,

7. By remaining in these regional traditional FFS plans, Medicare beneficiaries would be paying more precisely because they would be enrolled in less efficient, more expensive, plans.
8. CBO, "A Premium Support System for Medicare," p. 30.
9. Ibid., p. 26.
10. Ibid., p. 27.

which drives higher overall Medicare costs,[11] the MA payment model nonetheless results in unnecessary costs to seniors and taxpayers alike.[12]

Furthermore, the MA payment structure is irrelevant to the current debate on premium support; none of the major Medicare reform proposals replicates the flawed payment system. In its analysis, the CBO made several modeling assumptions,[13] including that the MA program would end, inasmuch as all beneficiaries would henceforth be able to choose among competing private, as well as Medicare FFS, plans.[14] With a new premium support program, the CBO estimates, private-plan bids would come in below current MA bids by roughly 4 percent.[15]

Some Reservations

The CBO acknowledges that its projections on future costs and savings are fraught with uncertainties. This is obvious. But analysts should also be cautious about certain assumptions underlying CBO estimates. Because of its modeling conventions, the CBO is unrealistically optimistic about Medicare's cost in 2020. The CBO is bound to follow certain rules in scoring policies, particularly the rule that requires the assumption of current law. But current law is an unrealistic guide. For example, under current law, Congress has authorized a 24 percent cut, mandated by the sustainable growth rate (SGR) formula, to Medicare physician payment in 2014. It is unlikely that the 24 percent cut will materialize, since Congress has historically overridden this formula-driven payment reduction to ensure continued physician participation in Medicare and protect patient access to care. Thus, future Medicare is far cheaper on paper than it will be in reality. Of course, if future Medicare is more expensive, premium support would generate proportionately greater savings.

The CBO also says that private insurers are unlikely to be able to "control" costs to providers the way traditional Medicare FFS does today. The stated reason: Medicare FFS relies on a system of administrative payments operating independently of private market forces, a system backed up by price controls on Medicare services. That system is subject to severe payment reductions authorized by the Patient Protection and Affordable Care Act of 2010. Such payment cuts and price controls are likely to result in an increasing number of medical professionals and providers unable or unwilling to meet the demand for medical services for the growing number of Medicare beneficiaries. Thus, the CBO is giving credit to Medicare FFS for its price controls and mandated payment reductions, assuming the cuts and payment reductions remain in effect, while the CBO publicly doubts that these reductions can be sustained. The Medicare Actuary shares these doubts.

Even in this latest premium support model, the CBO forecasts that traditional FFS provider costs will grow faster than their prices. This means that each year, doctors and hospitals would have fewer incentives to treat FFS patients, since such treatment is less profitable, and providers could incur losses treating Medicare beneficiaries.

In our view, Medicare costs under FFS are likely to be higher than official CBO projections because Congress would intervene to prevent a decline in beneficiaries' access to care. As a budgetary matter, if Medicare FFS costs increase, competing private plans would likely generate even more savings. It is also worth noting that there is a powerful interaction between Medicare and private-sector practice and performance. Dr. Amy Finkelstein, an economics professor at MIT, has published groundbreaking research showing that Medicare's growth was heavily influential in driving up expenditures of the entire

11. Christopher Hogan, "Exploring the Effects of Secondary Coverage on Medicare Spending for the Elderly," MedPAC, June, 2009, http://www.naic.org/documents/committees_b_senior_issues_110628_hogan.pdf (accessed January 15, 2014).

12. For a brief discussion of Medicare Advantage plan payment and the quality of care, see Jeet Guram and Robert Moffit, "The Medicare Advantage Success Story: Looking Beyond the Cost Difference," *The New England Journal of Medicine*, Vol. 366, No. 13 (March 29, 2012) pp. 1176–1179, http://phes.co/obj/Newengland/Ahmed/The%20Medicare%20Advantage%20Success%20Story%20%E2%80%94%20Looking%20beyond%20the%20Cost%20Difference.pdf (accessed January 15, 2014).

13. For example, the CBO assumed that traditional Medicare would retain its existing payment system and that Medicare Part D would continue to exist as it does today under current law. The CBO also assumed that dual eligible would not be included in the new system, nor would there be a "hard cap" on the rate of Medicare spending growth.

14. Likewise, in The Heritage Foundation proposal, Medicare Advantage plans are simply subsumed under the new premium support system.

15. CBO, "A Premium Support System for Medicare," p. 17.

health care industry.[16] Thus, a change in how Medicare finances and delivers medical care could also drive significant changes in private health spending. Medicare reform, based on a defined-contribution (premium support) system, unleashing an intense competition among health plans and providers, is likely to control health care costs throughout the health care system.

A Valuable Contribution

The CBO's recent analysis of premium support is clearly an improvement over the earlier scoring of the Medicare reform proposals, particularly the one offered initially by Representative Paul Ryan (R–WI), Chairman of the House Budget Committee. To their credit, CBO officials did concede that they did not then have the methodological capacity to model many aspects of Chairman Ryan's premium support plan comprehensively. The CBO now reports that there have "been substantial improvements in CBO's modeling" of insurer and consumer behavior.[17]

The CBO's latest modeling underscores the promising potential of premium support to control Medicare costs, even without taking into account potential spillover effects in the general health care economy. Refinements can always be made to any financing design, as can improvements in econometric forecasting. Other academic and public policy institutions, including The Heritage Foundation, can conduct in-depth quantitative research to reinforce the CBO's new modeling of market-based initiatives.

Thus far, the CBO has shown that Medicare premium support can yield serious savings while expanding seniors' options. Though a description, not a recommendation for action, the CBO's analysis affirms the potential of serious savings for Medicare beneficiaries and taxpayers alike. It also encourages a growing number of analysts who promote premium support as the single best option for comprehensive Medicare reform.

*—**Robert E. Moffit, PhD,** is Senior Fellow in the Center for Health Policy Studies at The Heritage Foundation. **Rea S. Hederman Jr.** is Director of the Center for Data Analysis, and the Lazof Family Fellow, at The Heritage Foundation.*

16. Amy Finkelstein "The Aggregate Effects of Health Insurance: Evidence from the Introduction of Medicare," *The Quarterly Journal of Economics*, Vol. CXXII, No. 1 (February 2007), http://economics.mit.edu/files/788 (accessed January15, 2014).

17. CBO, "A Premium Support System for Medicare," p. 29.