

Designing Competitive Bidding for Medicare

Medicare reimburses medical expenses for the elderly. Medicare is a federal insurance program. People pay into Medicare, and when they become eligible, their medical bills are paid from the trust funds which they paid into. Medicare primarily serves people over 65, whatever their income. Patients pay some deductibles for hospital and other costs. Small monthly premiums are required for non-hospital coverage.

Large numbers of HMOs exit the program if reimbursed too little. Since 1998, large numbers of HMOs have exited Medicare's coordinated care plan Medicare + Choice (now called Medicare Advantage), involuntarily un-enrolling hundreds of thousands of Medicare beneficiaries. These exits are due to the fact government-specified pricing for medical services causes Medicare to pay too much for some services and too little for others. Program payments to HMOs rarely reflect the variations in costs in different geographic areas.

The system needs a better way of determining the amount to be reimbursed. The system of setting M+C payments requires the Center for Medicare and Medicaid Services (CMS) to set HMO payments that accurately reflect the costs in the local market for each county of the United States. Ironically, while HMOs are exiting some counties, there has been healthy participation of HMOs in other counties, suggesting that CMS underestimates the costs of HMOs in many counties and overestimates costs in others.

Curiously, even with the growth of information technology, decision-makers do not have adequate resources to track the changes in healthcare costs in local markets in order to accurately set payments.

An alternative system is competitive bidding. However, previous efforts at sample competitive bidding projects approved by Congress were later blocked by local stakeholders. These stakeholder concerns need to be addressed as part of any successful program. The bidding process that CMS will design, and which the secretary of HHS will implement, is constrained by four peculiar institutional features:

In addition, a variety of market-like mechanisms are effective ways to incentivize individuals and businesses to do the right thing. Market tools include monetary incentives such as fees and subsidies; government-created markets for buying, selling, and trading emissions; deposit/refund systems that encourage recycling; and the disclosure of information to consumers. These mechanisms can motivate those being regulated to innovate and develop new ways to achieve the desired outcomes – reduced pollution – more than almost any other method. The solutions to environmental problems will come from grassroots efforts, but the central regulatory agencies and policy makers have to create the climate for that to occur.

- Transforming the system of administrative fiat to one based on a bidding process is an experiment.
- The bidding process will take place in segmented markets, which are marked by varying degrees of existing competition problems.
- The legislation requires a bidding process that has a unique role for the equivalent of a reserve price — the benchmark reimbursement rate.
- CMS must determine the structure of the asset for which coordinate care plans will bid, and it does so with some knowledge of the capabilities of bidders to participate.

Competitive bidding works better but takes skill to design and faces opposition. Competitive bidding can represent an improvement over fiat pricing when setting costs in different geographic areas. Properly structured, competing bids from managed care organizations provide CMS with the information it currently lacks – the geographical break-down of costs. Other healthcare programs have successfully used competitive bidding, including health insurance for federal employees, health insurance for military dependents and spouses, and markets for durable medical equipment.

Although changing methods and mindsets won't be easy, the current system of losing providers isn't working. Something has to change.

Key Success Factors. It is critical that a bidding system be carefully designed. Previous experience shows that poorly designed systems result in taxpayer expense and misallocated resources.

- The credibility of CMS matters. If CMS threatens not to accept any bids above a certain amount, the credibility of CMS to do so will affect plans' bidding strategies.
- Bidders often engage in collusive behavior to deter other bidders from entering.
- It is important to accurately set reserve prices (above which CMS will refuse to cover additional costs).
- Information asymmetries among bidders are important. ■

Resources

[John Cawley and Andrew Whitford "Designing Competitive Bidding for Medicare" \(IBM Center for The Business of Government\) 2004.](#)



This issue brief is one of a series of IBM Center for The Business of Government mission and program issue briefs prepared in anticipation of the 2008 national election and transition in government.

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