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Paying Medicare Advantage Plans: To Level or Tilt the Playing Field

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Abstract: Medicare beneficiaries are eligible for health insurance through the public option of traditional Medicare (TM) or may join a private Medicare Advantage (MA) plan. Both are highly subsidized but in different ways. Medicare pays for most of costs directly in TM, and subsidizes MA plans based on a “benchmark” for each beneficiary choosing a private plan. The level of this benchmark is arguably the most important policy decision Medicare makes about the MA program. Many analysts recommend equalizing Medicare’s subsidy across the options – referred to in policy circles as a “level playing field.” This paper studies the normative question of how to set the level of the benchmark, applying the versatile model developed by Einav and Finkelstein (EF) to Medicare. The EF framework implies unequal subsidies to counteract risk selection across plan types. We also study other reasons to tilt the field: the relative efficiency of MA vs. TM, market power of MA plans, and institutional features of the way Medicare determines subsidies and premiums. After review of the empirical and policy literature, we conclude that in areas where the MA market is competitive, the benchmark should be set below average costs in TM, but in areas characterized by imperfect competition in MA, it should be raised in order to offset output (enrollment) restrictions by plans with market power. We also recommend specific modifications of Medicare rules to make demand for MA more price elastic.

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