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Managed Competition: Hazardous to Your Health

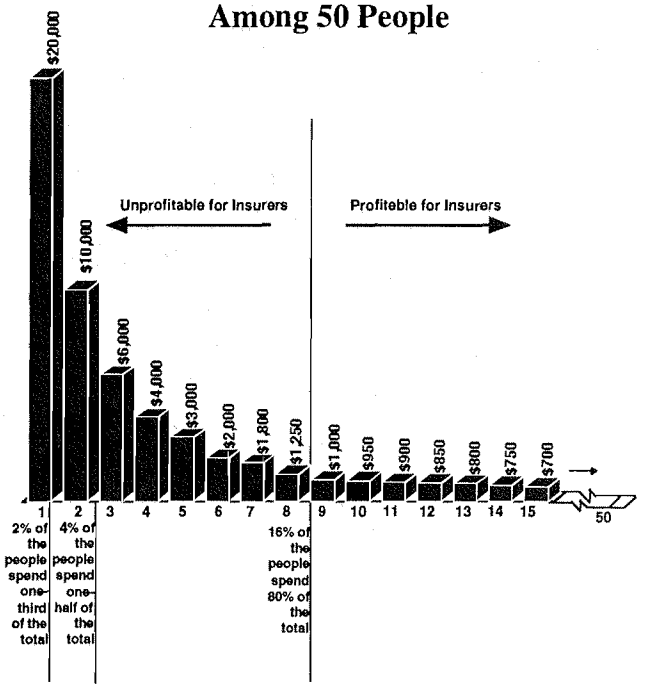
Managed competition is the central idea behind the Clinton administration's plan to reform the nation's health care system. It is also the main idea behind the four versions of the Clinton plan reflected in four different congressional committee bills. [See the NCPA Brief Analysis, "Managed Competition Is Back."]

How Managed Competition Works. The objective of managed competition is to create an artificial market for health insurance in which individuals choose among competing health plans that are forced to charge the same premium to every applicant, regardless of expected health care costs. Thus, among people entering or changing a health plan, a person who has AIDS would pay the same premium as someone who does not, and people in hospital cancer wards would pay the same premiums as people who do not have cancer.

Because of this one-price-for-all rule, the premiums sick people pay would be well below the expected cost of their treatment, while the premiums of healthy people would be substantially higher. As a result, the incentives for the plans to avoid sick people and attract healthy ones would be far greater than under the current system.

Background: Only a Few Spend Most of the Dollars. The distribution of medical expenses in Figure I is a reasonable representation of what happens in most insurance pools in any given year. In this case, a group of 50 people spend $60,000 on health care — $1,200 per person on the average. As Figure I shows, the distribution of expenses is anything but uniform. The vast majority of people incur costs well below the average, and most of the money is spent on a small number of people. Specifically:

FIGURE I
Distribution of Medical Expenses Among 50 People



- About 4 percent of the group (two people in this example) account for 50 percent of spending.
- About 16 percent of the people account for 80 percent of the spending.
- About 30 percent of the people account for 90 percent of the spending.

Result: Lower Quality Care for the Sick. Under managed competition, heart patients would tend to choose the health plan with the best cardiologists, and cancer patients would tend to choose the plan with the best cancer specialists. By contrast, healthy people would tend to choose plans with the best primary care services and amenities — secure in the knowledge that they could switch plans if they became seriously ill.

This would create extremely perverse incentives for the managers of the health plans. For example, *no plan could afford to have a reputation as being the best for those with expensive-to-treat illnesses.* Indeed, the plans that attracted a disproportionate number of sick people would eventually fail and leave the market. Moreover, each health plan would have an incentive to underprovide services to the sickest people and overprovide services to the healthy. Specifically:

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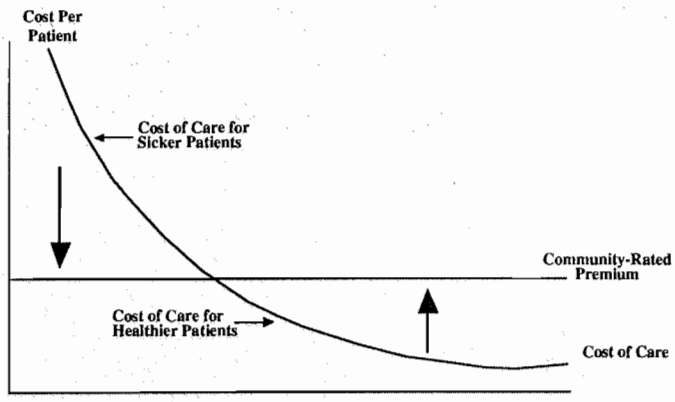
- The natural tendency of managed competition is to compete the amount health plans are willing to spend for the care of the sick down to the level of the premiums sick people pay.
- By contrast, there would be a natural tendency to compete the amount health plans are willing to spend on the healthy up to the level of the premiums healthy people pay.
- As a result, seriously ill people would be progressively denied access to the benefits of modern medical science, while healthy people would have access to services that are medically unnecessary and only tangential to health care.

Health policy analysts believe that the patients at greatest risk initially would be those with chronic conditions — those in need of mental health care, custodial care or long-term care. Where physicians have discretion, as in the treatment of leukemia or in efforts to save premature babies, the tendency would be to save money rather than prolong life. Expect a substantial decrease in the number of CAT and MRI scans and other costly tests that detect brain tumors, cancer and other life-threatening conditions. Where possible, expensive surgery (such as bypass operations) would be delayed — if for no other reason than that the patient might switch health plans and have the surgery performed by a competitor.

FIGURE II

Competitive Pressures under Managed Competition



Lessons From Other Regulated Markets. These conclusions follow from well-known principles of the economics of regulation. In competitive markets, price tends to change until it equals average cost. [See Figure II.] But if prices are constrained, competition will cause cost to change until it equals price, primarily through changes in quality. For example, when housing rents are kept artificially low by rent control, landlords tend to allow housing quality to deteriorate until their costs fall to the level of the government-controlled rents. When airline regulation kept airfares artificially high, the airlines tended to increase quality by adding more flights and amenities until their costs rose to the level of the government-controlled fares.

A different way of appreciating this result is to consider it in terms of a basic principle taught in all introductory economics courses: when firms are maximizing profits, marginal revenue must equal marginal cost. Under managed competition, marginal revenue (the amount of premium each enrollee brings to a plan) must be the same for every enrollee. That means that marginal cost (the amount the plan spends on health care for a patient) must also be the same for every enrollee.

Pressures for More Regulation. In order to preclude the disaster just described, advocates of managed competition would try to restrain perverse behavior by (a) limiting "open enrollment" periods during which enrollees could change plans, (b) insisting that everyone have the same package of health insurance benefits, (c) requiring everyone to have the same deductibles and copayments, (d) transferring income back and forth among insurers under risk adjustment schemes and (e) imposing regulations designed to prevent the deterioration in quality of care.

But because these restraints would not correct the fundamental problem — incentives distorted by artificial prices — they are unlikely to make managed competition workable. And each new set of regulations is likely to create pressures to enact even more regulations.

Recommended Reading: *John Goodman and Gerald Musgrave, "A Primer on Managed Competition," NCPA Policy Report No. 183, April 1994.*