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MARKETS WITHOUT MAGIC: *How Competition Might Save Medicare*

By Mark V. Pauly

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There is no magic that can preserve Medicare as we know it today. As the baby boomers age and as medical advances spur costlier health services, this enormously popular program—which helps pay the health care costs of 43 million seniors and disabled Americans—is headed for financial crisis. The tax burden that Medicare creates is on track to more than triple within the next three decades. The resulting clash between the interests of older and younger taxpayers will eventually force politicians to renege on Medicare's promise of virtually unlimited resources for health care. One way or another, we must find a way to slow the rate of growth in taxpayer-financed funding for Medicare in order to make the program financially sustainable.

In *Markets Without Magic: How Competition Might Save Medicare* (AEI Press, 2008), Wharton economist Mark V. Pauly argues that unavoidable limits on Medicare financing can best be imposed through market-based choices rather than government direction. Policymakers face a fundamental challenge: how to preserve Medicare's ability to provide financial protection and access to effective medical care to its beneficiaries while securing the advantages of competition? A voucher system could provide full coverage for the poor, ensure all seniors have access to a minimum level of coverage, and empower consumers to make decisions about their health care.

In the short run, bringing competition to Medicare will save money for beneficiaries and improve the quality of health care; in the long run, it may save Medicare. Pauly suggests we build upon the success of the Medicare Advantage program, which gives beneficiaries private insurance alternatives to the traditional government-managed Medicare program. Pauly proposes to convert the traditional Medicare program to an explicit voucher, operating under the same rules as the private plans. This would create a neutral Medicare market and provide a mechanism for setting realistic limits on the growth in spending. Competition would promote efficiency and give seniors the freedom to decide how to economize on spending growth.

Pauly also debunks common objections to a market-based Medicare system:

- *Consumers would be confused by the plethora of choices*. Pauly agrees that efforts should be made to provide clear information about plan options for consumers, but he also notes that the system will function efficiently even if not all consumers are able to make perfectly well-informed choices. A critical mass of reasonably well-informed buyers choosing among a reasonably large number of competing suppliers is enough to enforce market discipline and promote efficiency. Government regulation to require plans to offer reasonable benefits and access to providers would also enhance protections for consumers. Pauly also calls for a government-run, competitive Medicare plan that would provide a "safe harbor" for individuals who cannot decide between plans.

- *Cherry-picking would result in uneven coverage for those with higher health risks.* In a market-based system, some insurers may favor those in good health and stint on care for higher-risk customers. The solution to this problem is to adjust premiums and subsidies to reflect the financial risk of each beneficiary, providing high-risk individuals with more generous subsidies.

- *Traditional Medicare has more market power and would do a better job of controlling costs than competing health plans.* Despite traditional Medicare's power to offer health services for lower-than-prevailing prices, the program's reluctance to reduce access for beneficiaries has limited its ability to control costs. Medicare's "clout-based" pricing incurs higher spending than that of competing plans—with the higher costs concealed by financial transfers extracted from providers.

Pauly concludes that Medicare can avoid an impending financial crisis only by implementing a market-based approach to health insurance. A limited-growth voucher system would contain costs and keep benefits available. Competition among plans would save money for beneficiaries, who could choose the plan most suitable for them at the quality level they prefer.

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