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Cross Subsidization and Multiproduct Strategies in Medicare Advantage

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Abstract:

"In 2011, PFFS plans in counties with two or more coordinated care plans with established networks were required to establish their own networks in a government response to rising Medicare Advantage costs. In response, insurers decreased PFFS offerings, but also decreased HMO plans and increased PPO plans. Hence, the shock to PFFS plans affected the entire Medicare Advantage market. My goals then are to:
1. theoretically motivate why plan offerings changed by proposing an extension to Bresnahan and Reiss (1991)'s entry model;

2. introduce the possibility of firms engaging in risk selection by taking advantage of product differentiation and differentiated consumer preferences across their own plan types, which I term cross-subsidization strategies and are an advantageous selection mechanism that has not been previously studied;

3. detect the prevalence of cross-subsidization strategies;

4. calculate the effect of cross-subsidization strategies on consumer welfare.

"I use publicly available data from CMS on Medicare Advantage from 2007-2011 and county-level data. I take advantage of a policy change in 2011 to provide exogenous variation in fixed costs. Because the change in fixed costs changes entry across all plan types, my theoretical model predicts that the success of cross-subsidization strategies should change, thus affecting the structure of the market. I first carry out a series of reduced form regressions to detect cross-subsidization in markets. Because cross-subsidization primarily affects the marginal costs of plans, I then use a model of consumer discrete choice and impose supply-side restrictions to extract plan marginal costs and to detect whether a firm is using a cross-subsidization strategy. Using the demand-side estimates, I run simulations to calculate the change in consumer surplus when cross-subsidization market conditions change. Medicare Advantage insurers and eligible enrollees My study finds that increasing both fixed costs from operating portfolios with PFFS plans and cross-subsidization barriers decreases the likelihood that new entrants will enter the market with mixed portfolios. However, if increased fixed costs coincide with decreased cross-subsidization barriers, then the effect on new entry with mixed portfolios becomes nebulous. Results expected in April 2013 will determine the effect of decreased likelihood of cross-subsidization strategies on consumer welfare. Theoretically, decreased cross-subsidization implies less plan choice, which may

decrease welfare, but may also decrease insurer mark-ups, which are welfare-enhancing. I find that insurers may take advantage of differences in fixed cost and consumer preferences across plan types to leverage their market power, by engaging in advantageous selection through cross-subsidization. Furthermore, an external government intervention to increase the fixed cost of entry for one plan type may limit the ability to cross-subsidize across plans, thus decreasing plan offerings in markets. This study will evaluate whether the policy in 2011 directed to combat the high costs of Medicare Advantage was effective, whether access and consumer choice was impacted negatively by unanticipated effects from cross-subsidization strategies, and whether the government should limit cross-subsidization strategies among firms by limiting product differentiation.