

Privatizing Medicaid in Colorado (IP-1-1993)

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Issue Paper

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For many years virtually everyone has agreed that the current Medicaid system is broken, but instead of fixing it we simply throw more money at it. Medicaid costs rise far faster than the rate of inflation or the rate of health care cost increases. Yet few people believe that Medicaid adequately provides essential health care for the needy.

The Medicaid system was created in 1965 as an amendment to the Social Security Act of 1935. The program provides medical assistance to certain impoverished persons who are aged, blind, or disabled, or members of families with dependent children. According to the Congressional Budget Office, about 15 million nonelderly Americans are covered by Medicaid. Medicaid is funded from federal and state tax revenues.

From the outset the costs of the Medicaid program have increased more rapidly than costs for health care services in general, and each year account for a larger share of total health care dollars spent in this country. In recent years the costs of Medicaid have increased at a very rapid rate and have absorbed a larger share of both state and federal tax dollars. In Colorado, for example, during fiscal year 1990/91 the legislature spent \$28.3 million in excess of the general funds appropriated, and most of that excess spending was accounted for by unanticipated higher costs of the Medicaid program.

These higher costs of Medicaid created several problems for the state legislature. The excess expenditures left a year-end balance of \$36.5 million, which is \$42.3 million shy of the 3% required reserves. More importantly, the increased spending for Medicaid left very little discretion for the legislature to allocate funding for other important programs such as highways, capital construction, or education. Medicaid costs are projected to spiral at an even higher rate and will absorb an even larger share of state expenditures in future years. These problems have created pressures to reform the Medicaid program in Colorado, and several reform measures have been introduced in the Legislature. In this issue paper we explore the reasons for the failure of the Medicaid Program, propose a solution to the problem through privatization, and critically evaluate alternative proposed reforms of medical care in Colorado.

I. WHY THE MEDICAID PROGRAM HAS FAILED

The fundamental reason why Medicaid costs have increased so rapidly is that there is no incentive for anyone to constrain and reduce those costs. The rising costs of Medicaid reflect both an increase in the number of people eligible for these services, and increased intensity of use of those service. The problem on the demand side is that the consumers of Medicaid services do not pay for them, as a result they treat those services like a free good. The outcome is exactly what we would expect, the growth in demand for Medicaid services far outstrips the growth in supply. Since the Medicaid Program went into effect more than half of the increase in costs have been due to higher prices for physicians services and hospital care. Unfortunately higher prices for Medicaid services do not deter the demand for those services, as do higher prices in private markets. The higher costs of Medicaid services are borne by the millions of taxpayers who finance Medicaid through federal and state taxes. Unfortunately, taxpayers have neither the ability nor the incentive to constrain those costs. Indeed, it is fair to say that neither the consumers of Medicaid services, nor taxpayers, are even aware of the higher cost of those services.

On the supply side the providers of Medicaid services do not have an incentive to reduce costs. In fact providers of health care services under Medicaid may act in their self interest to increase costs, by expanding the range and quality of health care services provided, and by increasing the price of those services. In some cases the cost of health care services provided under Medicaid may reflect pure rent seeking, e.g. poor quality services, overstaffing, and bureaucratic waste.

II. A VOUCHER SYSTEM FOR HEALTH CARE IN COLORADO

The Medicaid Program will only be fixed when there are incentives to constrain and reduce costs, and the best way to do that is to privatize it. Privatization is a broad term encompassing the shift of activities from the public sector to the private sector. The key questions in any privatization program are (1) who pays for the activity, and (2) who produces or delivers it. the following scheme illustrates the different possibilities in privatization.

In the traditional activity the government both pays for the service and provides it. When the government produces the service but charges the users for the cost (via user fees) this privatizes the payment but not the delivery of the service. Privatization is often used to describe the process whereby the production of the service is transferred from the public to the private sector. The most common form of this privatization is contracting out or outsourcing. In some cases the government may act as the citizens purchasing agent, seeking bids from competing suppliers for the right to deliver the service. The voucher is a unique form of contracting out in which eligible citizens receive vouchers from the government, but the citizens themselves act as their own purchasing agents in selecting among competing suppliers in the private sector. Finally, privatization may shift both the purchase of the service and the

provision of the service from the public to the private sector. This latter form of privatization is usually achieved through franchising or divestiture. The privatization of the Medicaid Program in Colorado proposed in this study combines several of these techniques in privatization. In the following section we describe how a Voucher System for Health Care in Colorado would work.

A. Who would receive vouchers for health care in Colorado?

Persons eligible for vouchers would include: Medicaid recipients; persons whose income is equal to or less than 150% of the federal poverty level and who are not covered under an employer provided health care plan; certain persons whose income is more than 150% of the federal poverty level and who are not covered under any health insurance or health care policy, contract, or plan; and persons unable to obtain health insurance coverage due to medical underwriting considerations.

B. Who would administer the Voucher System For Health Care in Colorado?

The Department of Social Services would administer, implement, and monitor the Voucher System, determining eligibility, issuing proof of eligibility forms, determining reimbursable premium amounts, and establishing procedures for the reimbursement of insurers. The Department of Social Services would be required to issue to eligible persons a proof of eligibility form entitling the person to coverage under any health insurance or health care policy or contract in the amount of the premium indicated on the form and for a policy or contract period of one year. The cost of the policies and contracts would be required to be equal to the reimbursable premium amount indicated on the proof of eligibility form. The policies and contracts would not be subject to certain mandated benefits or minimum policy or contract benefits.

C. Who Would Provide Medical Insurance Under the Voucher System?

Every insurer authorized to do business in the State of Colorado would be required to offer individual health insurance or health care policies or contracts to any person who presents proof of eligibility form or to offer group health insurance or health care policies or contracts to any person, as policyholder or contract holder, who presents a proof of eligibility form for each member of the group.

D. How would the Voucher System for Health Care in Colorado be funded?

Funding for the Voucher System for Health Care in Colorado would be provided by the following sources to be placed in a Health Care Access Fund to be used solely for the purpose of reimbursing insurers for the provision of health insurance or health care policies and contracts to persons eligible for the program benefits.

1. Federal payments received as a result of waiver of requirements under the

health care programs.

2. State moneys in an annual amount equal to the money appropriated for expenditure for purposes of the medical assistance programs.

3. Premiums paid by recipients of the health care services provided under the Voucher System. The Medicaid recipients would not pay copayments or deductibles. However other persons eligible for the Voucher System would be expected to pay reasonable deductibles and copayments on a sliding scale based upon their income. The payment of these expenses would create incentives for those utilizing the Voucher System to carefully select their insurer, health care providers, and the kind of health care services provided.

4. Any grants and gifts from the public or private sector, and income earned on the funds allocated to the Voucher System.

E. How would the Voucher System for Health Care in Colorado create incentives for cost containment and cost reduction?

The Colorado Department of Social Services would be required to establish and implement a program whereby a portion of the premium for coverage, other than coverage for preventive care, would be required to be refunded by the insurer to the person if the total amount of the claim submitted under a persons coverage is no more than 20% of the premium for the coverage or if the benefits under the policy or contract for emergency room services are not utilized by the person:

1. If the total amount of the claims submitted is equal to or less than 10% of the premium cost, the refund would be \$100.

2. If the total amount of claims submitted is equal to or less than 20% of the premium costs, but more than 10% of the premium cost, the refund would be \$100.

3. If the benefits for emergency room services are not utilized by the person, the refund would be \$100.

4. If the covered person identifies on a billing statement any item or service that was not received by or rendered to the person for which the person was overcharged, the insurer would be required to refund a certain amount to the person covered by the program and the provider that overcharged or incorrectly billed the person would be required to reimburse the insurer 125% of the overcharged or incorrectly billed amount.

5. Each physician would be required to compile a list containing the usual and customary charges that are charged by the physician for his most common services and would provide that if a physician charges a patient more than \$500 for services rendered the physician would be required to inform the

patient of the availability of the list and to provide the patient a free copy of the list.

The rationale for the Voucher System for Health Care in Colorado is that this reform would create incentives for both consumers and suppliers to improve efficiency and productivity, and lower the costs of these health care services. In effect the Voucher System would create a competitive market for the provision of health care through private insurers. The voucher system could be implemented to cover not only those currently eligible under Medicaid, but also many of those not now covered by any health insurance program. Preliminary estimates show that the Voucher System for Health Care in Colorado can be implemented without increasing the cost from current levels of federal and state funding for the Medicaid Program. Other states, such as Ohio, have already introduced enabling legislation to replace the Medicaid Program with a Voucher System along the lines proposed in this issue paper. The Bush administration has now directed federal administrators to encourage just such reform through waivers under the Medicaid Program. The opportunity for reform now exists, and the pressure for reform is mounting in states such as Colorado confronted with spiraling costs of the Medicaid Program.

III. A CRITICAL APPRAISAL OF ALTERNATIVE APPROACHES TO HEALTH CARE REFORM IN COLORADO

The proposed Voucher System for Health Care in Colorado would be superior to alternative proposals now before the Colorado Legislature such as COLORADO CARE, and UHICO. These alternative proposals have been described elsewhere, and therefore will not be described here. However it is important to point out fundamental flaws in these alternative approaches to health care reform.

Basically these alternative proposals would end up expanding the role of the public sector in the provision and financing of medical care services; in other words they propose just the opposite of the privatization of the Medicaid Program proposed in this study. Not only would these alternative proposals fail to address the fundamental problem of cost containment and cost reduction, they would create exactly the opposite incentives for increasing costs through expanded public provision and financing of health care services. Not the least of these increased costs would be associated with increased rent seeking by an expanded public health care bureaucracy, especially if that bureaucracy is given a legal monopoly for the provision of medical care services.

It is not always clear how the increased costs for medical care services would be funded in these alternative proposals, however several expanded sources of funding are mentioned including: increased income taxes at the state and federal level, higher sales and excise taxes, higher payroll taxes, head taxes

on students, and increased taxes on those who are not working and are not poor. Both of these alternative proposals would shift a substantial part of these costs to employers. The outcome would be reduced incentives for business' to invest and to provide employment opportunities. Both of these proposals would continue to tie the provision of health insurance to employment. When an individual's health care insurance is tied to their employment, they lose their eligibility for that health insurance when they become unemployed or change employers. In contrast a voucher system places the choice of health insurance in the hands of the eligible individual, independent of their employment.

One bill before the Colorado legislature would link funding for medical care services to increased tobacco taxes. There is a growing group of nonsmokers who advocate higher taxes on the smoking population because they dislike that lifestyle choice. If we are to take this punitive approach to taxation in order to finance medical care services then we should also impose punitive taxes for other lifestyle choices. For example, a major portion of medical problems and medical costs in this country can be attributed to overeating. Yet no-one has proposed a 'fat tax' on all fat people to finance these medical costs.

The bankruptcy and cynicism of such punitive approaches to taxation and reform of medical care is obvious; what is somewhat surprising is that legislators would respond to these pressures. There is only one explanation for the attempt by legislators to financing medical care services by increasing tobacco taxes, and that is rent seeking. Politicians find that the smaller share of the population smoking does not mount much resistance when they maximize government revenues by increasing tobacco taxes. Politicians can not only generate more revenues, they can also garner the support of that portion of the nonsmoking population that supports punitive taxes on the smoking population. This conclusion is supported by evidence for tobacco taxes in Colorado. Tobacco tax revenues have been basically flat for several years, and are expected to decline in future years with a decline in the smoking population and decreased expenditures for tobacco. Any revenues generated by higher tobacco taxes would pay for a small and declining fraction of medical care costs. Shifting a larger share of the financing of medical care costs on the declining share of the population that smokes would be both regressive and inefficient.

The fundamental problem with medical care in Colorado is not with the lifestyle choices that people make, but rather with a Medicaid Program in which costs are out of control, and in which there is no incentive to constrain and reduce those costs. The fundamental flaw in alternative proposals for reform of health care is that they fail to address this problem, indeed they would most likely exacerbate the problem. It is this fundamental problem of rising costs that the proposed Voucher System for Health Care in Colorado is

best designed to address.

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