

The Excess Cost of the Medicare Drug Benefit

Republican's prescription drug program costs \$800 billion more than a direct Medicare benefit with negotiated prices

February 2006



I N S T I T U T E F O R
A M E R I C A ' S F U T U R E

1025 Connecticut Ave., NW #205 Washington, DC 20036
(202) 955-5665 www.ourfuture.org

The Excess Cost of the Medicare Drug Benefit

By Dean Baker, PhD

The waste and inefficiency built into the structure of the 2003 Medicare Modernization Act (MMA) will add more than \$800 billion to the cost of prescription drugs to the government and beneficiaries over its first decade, compared to a drug bill designed to maximize efficiency. The most simple and efficient way to cover the cost of prescription drugs would have been to establish a simple add-on to the basic Medicare program, comparable to the prescription drug benefit provided by most private health insurers.

Instead, Congress deliberately structured the bill to ensure that multiple private insurance companies would provide the benefit rather than Medicare. This design substantially increased the cost of the program for seniors and the disabled, leaving many with large drug expenses. The structure designed by Congress also made the program more costly for the federal government and state governments as well. In addition, it is very difficult for most beneficiaries to understand the differences between the policies offered by private insurers under the MMA. As a result, millions of beneficiaries may end up not getting any help at all in paying for their prescription drugs.

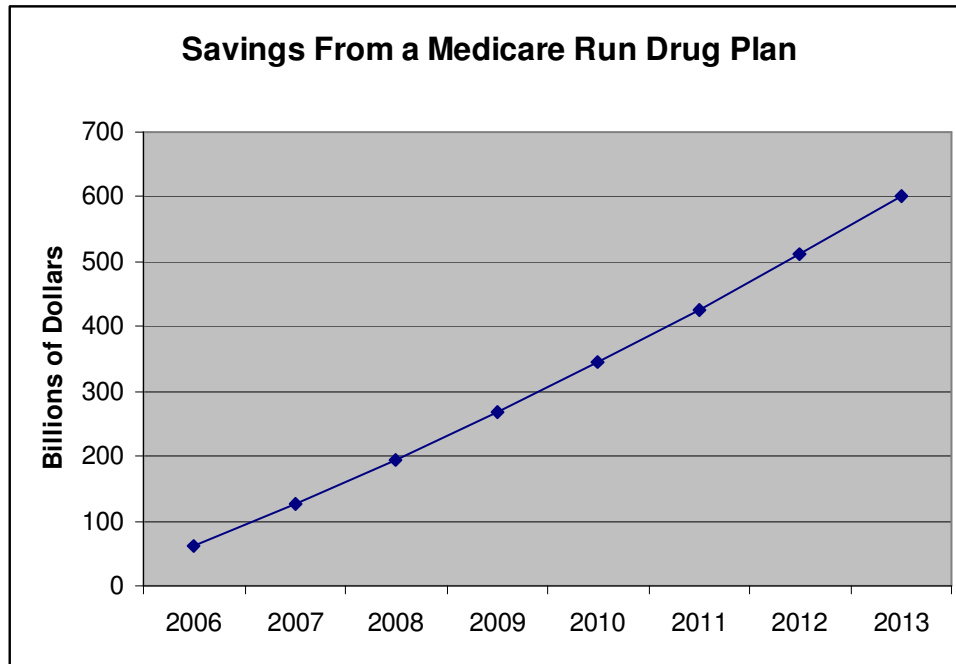
The waste built into the MMA is easy to show based on projections from the Congressional Budget Office (CBO).¹ CBO projected that the marketing and the profits of the insurance industry would add \$38 billion to the cost of the MMA over the first eight years of the program's existence (2006-2013) budget window, compared to a program that was administered through Medicare.² If Congress had instead created an add-on benefit to the existing Medicare program, this money either could have been used to create a more generous benefit or to finance federal and state spending in other areas.

The \$4.8 billion in wasted administrative costs under the MMA is approximately equal to two-thirds of the annual appropriation for Head Start. However, the much bigger source of waste in the MMA is the excess payments to drug companies due to the fact that Medicare is not allowed to use its bargaining power to gain discounts from the industry. Virtually every other country in the industrialized world imposes some constraint on drug prices, either through formal price controls or government negotiated prices.³ As a result, people in other countries pay much lower prices than do people in the United States. In a recent study, CBO assessed drug prices in several other wealthy countries. It found that consumers in these countries pay on average between 35 and 55 percent less than consumers in the United States. The discounts obtained by the Veterans Administration were even larger.⁴

If Medicare was allowed to use its bargaining power to negotiate prices on behalf of beneficiaries, it could almost certainly obtain discounts that are at least as large as the highest discounts obtained in other countries, since it would be by far the biggest drug buyer in the world. If Medicare could negotiate the same schedule of prices as Australia (the current lowest cost country), the savings over the first eight years of the drug benefit would be almost \$560 billion.

The combined savings from having Medicare negotiate prices directly with the industry and from having Medicare directly offer the benefit instead of private insurers would be more than \$600 billion over the years from 2006 to 2013, as shown in Figure 1.

Figure 1



Source: CBO and Baker 2006.

These savings are so large, that with the money appropriated in the MMA, it would be possible to fully pay for all drugs for Medicare beneficiaries, with no premiums, deductibles or co-payments. Alternatively, it would be possible to have a modest schedule of co-payments, comparable to those in most private health insurance plans, and save the federal and state governments more than \$100 billion compared to the spending projected in the MMA.

If Congress were to restructure the program and allow the Medicare system to negotiate directly with drug companies and to offer a plan that competed with the plans offered by private insurers (as the current Medicare system does more generally under the Medicare Plus Choice program), then it would be possible to recoup much of the unnecessary waste incurred due to the structure of the MMA. The savings would be roughly proportionate to the share of Medicare beneficiaries who signed up with the new Medicare-run plan. For example, if 50 percent of the beneficiaries signed up with the Medicare-run plan, the total savings to the beneficiaries and the government would be approximately \$400 billion over the first ten years. If 80 percent of beneficiaries opt to join the Medicare-run plan (more than 85 percent of beneficiaries opt for the traditional Medicare insurance rather than Medicare funded H.M.O.'s) then the savings would exceed \$640 billion over the first ten years.

While the huge savings from a Medicare-managed drug plan would be very important, the greater simplicity could be almost as important to beneficiaries. There is no reason to force seniors to struggle with complex pricing and payment schedules to determine the drug plan that is best for them. A simple benefit provided through the Medicare program could save beneficiaries the hours needed to choose between the long list of insurance companies offering plans under the MMA. It would also save beneficiaries the anxiety that they may still make the wrong choice and find themselves needing drugs that are not covered under the plan that they have selected.

Usually there is a trade-off between simplicity and cost, where it is more costly to keep everything simple for users. In the case of the Medicare drug benefit, the opposite is true. The simplest route would have been to include a drug benefit as an add-on to the existing Medicare program, following the example of most private health insurance plans. This simple route would have saved beneficiaries and the government more than \$600 billion over the first eight years of the program's existence. Both beneficiaries and the government are paying the price of not having followed this simple route.

¹ This discussion is based on the analysis in Baker, D. 2006, "The Savings From an Efficient Medicare Drug Plan," Washington, D.C.: Center for Economic and Policy Research [http://www.cepr.net/publications/efficient_medicare_2006_01.pdf].

² Congressional Budget Office, 2004a. "A Detailed Description of CBO's Cost Estimate for the Medicare Prescription Drug Benefit," Washington, D.C.: Congressional Budget Office [<http://www.cbo.gov/showdoc.cfm?index=5668&sequence=0>], Table 3.

³ It is important to remember that the government is granting the pharmaceutical companies patent monopolies, which is what allows them to charge high prices in the first place. The question is not whether companies can sell their drugs in a free market, the question is whether the government will grant drug companies an unconstrained monopoly or whether it will impose some limits on the extent to which drug companies can exploit their patent monopolies.

⁴ CBO, 2004b, "Would Prescription Drug Importation Reduce U.S. Drug Spending?" Washington, D.C.: Congressional Budget Office, Page 4.