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# Medicare versus Private Health Insurance: The Cost of Administration

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One of the most common, and least challenged, assertions in the debate over U.S. health care policy is that Medicare is much more efficient than the private sector. Critics of the private sector health insurance industry like to boast that Medicare administrative costs are about 2 percent of claims costs, while private insurance companies' administrative costs are in the 20 to 25 percent range—or more.

That assertion is nearly always followed by a policy recommendation: Switch everyone to a government-financed health care system, or just put everyone in Medicare, and the country will save so much in administrative costs that it can cover all of the 46 million uninsured with no additional health care spending.

Milliman, Inc., recently completed a study on behalf of the Council for Affordable Health Insurance (CAHI) that compares the administrative costs of Medicare to that for the private insurance industry on average. The full report is available by contacting CAHI via phone at (703) 836-6200 or by e-mail at [mail@cahi.org](mailto:mail@cahi.org). This article summarizes the results of the study.

Medicare costs include those reported by Medicare, plus an allocation of some overhead costs that are included in other parts of the federal budget, but are estimated per this study to belong to Medicare. Private market costs recognize the

aggregate average cost as estimated across all three private markets (individual, small group and large group). All overhead costs are included as private companies must allocate costs by function. Private market costs for commissions, premium taxes and profit are shown separately as government does not have such costs.

The study estimated that Medicare administrative costs during 2003 were lower as a percentage of claim costs than private health insurance administrative costs for functions that were readily comparable. Medicare administrative costs were estimated at 5.2 percent of total costs (benefit payments plus administrative costs) and private insurance administrative costs were estimated at 8.9 percent of total costs (premiums). But this comparison does exclude some significant differences between Medicare and private health insurance.

In 2003, the average medical cost for Medicare was estimated to be about \$6,600 per person per year (because of the nature of Medicare's beneficiary pool: older and disabled people), while the average medical cost for private health insurance, excluding out-of-pocket cost, was \$2,700 per person per year. Because of the higher cost per beneficiary, Medicare's method of calculation makes administrative costs higher as a percentage for commercial insurance, but lower when calculated as a PMPM. The right answer is somewhere between a percentage of premium and a PMPM, but the point is an important one when trying to make comparisons.

The chart on page 29 summarizes estimated administrative costs on this same basis under Medicare for selected years from 1967 through 2025 and compares them to private health insurance administrative costs (note that private insurance costs as a percentage of total costs are expected to remain constant). Private costs are shown without and with commissions, premium taxes and profits (this is discussed later).

## Administrative Costs as a Percentage of Claims plus Expenses

Medicare						Private Health	
1967	1985	2003	2010	2017	2025	No commission, premium tax, profit	With All Expenses
17.0%	7.2%	5.2%	3.3%	2.4%	1.6%	8.9%	16.7%

Some comments on the comparisons above are as follows:

- ◆ Administrative costs are higher than reported in the Federal budget (about 2 percent).
- ◆ Medicare administrative costs are expected to decrease over time because Medicare benefit costs increase at a higher rate than administrative costs. Annual benefit costs have typically increased at a rate about double normal inflation (CPI increases) whereas administrative costs have typically increased closer to the CPI rate.
- ◆ The private market administrative costs are expected to remain at about 9 percent of total private insurance cost, excluding premium taxes, commissions and profit. With such items, private costs would be slightly under 17 percent. While we have not studied private costs at various points in time, a look at costs in the early 1990s indicated administrative costs in roughly the same place, although there have been changes in certain markets.
- ◆ Other significant differences exist between Medicare and private health insurance, which could significantly alter the comparison if recognized as discussed below.

One significant difference between Medicare and private health insurance is that the accounting is fundamentally quite different, making comparisons of costs under each program very difficult. Medicare uses pay-as-you-go funding, meaning that costs are not funded until they come due. When due, some of Medicare's funding comes from the Federal Treasury, which may need to borrow some of this money. On the other hand,

private insurance has to prefund costs through reserves backed by hard assets. It may raise capital to do so, and profits can effectively be a return of this capital. This means any costs to raise capital are immediately included in the total costs of running a private health insurance business.

Another significant difference is that private programs may have administrative functions not applicable to Medicare. These can include commissions, premium taxes and profits. Some private programs have such costs where others do not. In the study, commissions, premium taxes and profits are shown separately and comparisons of Medicare to private health insurance can either include or exclude such costs.

Specific functions applicable to potential administrative costs are briefly described below. The initial group includes those applicable to both Medicare and private health insurance. Functions applicable to Medicare or private health insurance only are shown in separate groupings.

### Medicare and Private Health Insurance Administration

- Claim payment administration/adjudication: This represents the payment of claims, including the various functions related thereto.

- Policyholder services: This represents addressing consumer questions regarding policy or coverage administration.

- Marketing: Advertising, printing, related mailing costs and general selling costs. Commissions are excluded.

- Systems: Setting up and maintaining reporting systems for the business.

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- Actuarial and accounting: The necessary maintenance of the business relative to funding, estimating, reporting, etc.

- Compliance: Process to verify, confirm and implement the following applicable laws and rules.

Profit: This item applies only to private insurance. Profit is included or excluded in the study as indicated.

The administrative costs as shown in the article are on a best estimate basis only. Sensitivities are discussed in the study itself.

Medicare costs in the study are based on the federal budget, Medicare trustee reports and other government reports. Private industry costs are based on national health care expenditure data, Milliman data, and experience and judgment of the authors.

For a better understanding of the results and limitations of the study, the entire report should be read. 📖

### **Some of the revenues used may include funds emanating from monies borrowed by the federal Treasury.**

- Peer review: The review of administrative processes, including functions above.

- Overhead: Building costs, salaries not included elsewhere, and other costs not included elsewhere.

### **Medicare Only (excluded from study)**

Potential costs related to funding shortfalls: Medicare in general pays providers and others as costs emerge. Some of the revenues used may include funds emanating from monies borrowed by the federal Treasury. These borrowed amounts are effectively unfunded liabilities until the day they are funded. Should potential costs related to this borrowing be attributed to Medicare? This question is beyond the scope of this article and the study presented, but is anticipated to be addressed in a subsequent study.

### **Private Insurance Only (reported in the study separately)**

Commissions: They apply only to private health insurance. Self-funded plans within private insurance do not have this component. Commissions are included or excluded as indicated.

Premium Taxes: These are amounts charged by states to, at least in theory, cover the costs of regulating private insurers. No such cost applies to the Medicare Administration. Premium taxes are included or excluded in the study as indicated.



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