



Medicare's Hidden Administrative Costs:

A Comparison of Medicare and the Private Sector

(Based in Part on a Technical Paper by Mark Litow of Milliman, Inc.)

By Merrill Matthews, Ph.D.

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Council for Affordable Health Insurance
127 S. Peyton Street, Suite 210
Alexandria, VA 22314
Phone: 703/836-6200 Fax: 703/836-6550
Email: mail@cahi.org
www.cahi.org

*For additional information please contact the Council for Affordable Health Insurance at 703/836-6200 or
by email at publications@cahi.org.*

Executive Summary

One of the most common, and least challenged, assertions in the debate over U.S. health care policy is 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.

It is very difficult to do a real apples-to-apples comparison of Medicare's true costs with those of the insurance industry. The primary problem is that private sector insurers must track and divulge their administrative costs, while most of Medicare's administrative costs are hidden or completely ignored by the complex and bureaucratic reporting and tracking systems used by the government.

This study, based in part on a technical paper by Mark Litow of Milliman, Inc., finds that Medicare's actual administrative costs are 5.2 percent, when the hidden costs are included.

In addition, the technical paper shows that average private sector administrative costs, about 8.9 percent – and 16.7 percent when commission, premium tax, and profit are included – are significantly lower than the numbers frequently cited. But even though the private sector's administrative costs are higher than Medicare's, that isn't "wasted money" that could go to insuring the uninsured. In fact, consumers receive significant value for those additional dollars.

We also raise an important, although heretofore unrecognized, issue that gives Medicare an inherent advantage on administrative costs. Because of the higher cost per beneficiary, Medicare administrative costs *appear* lower than they really are. If the numbers were adequately "handicapped" for comparison with the private sector, they would be in the 6 to 8 percent range.

Finally, like the private sector, Medicare also has to obtain funds to pay claims. But the cost of raising that money, or borrowing it if the government doesn't collect it from taxpayers, is excluded from Medicare administrative cost calculations. While we don't in this paper draw any conclusions about what we shall call the "cost of capital" and its impact on Medicare's administrative costs, we do want to highlight that those costs exist and that taxpayers, both today and in the future, must bear those costs.

Introduction

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.¹

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.²

Sound too good to be true? It is.

Medicare's Administrative Costs, Past and Present

It is very difficult to do a real apples-to-apples comparison of Medicare's true costs with those of the insurance industry. The primary problem is that private sector insurers must track and divulge their administrative costs, while most of Medicare's administrative costs are hidden or completely ignored by the complex and bureaucratic reporting and tracking systems used by the government.

CAHI's 1994 Study. In 1994, the Council for Affordable Health Insurance (CAHI) published "Rhetoric vs. Reality: Comparing Public and Private Health Care Costs," authored by Mark Litow, a consulting actuary with Milliman & Robertson (now Milliman, Inc.), and CAHI's Technical Committee (now the Research and Policy Committee). The study found that when all of the hidden costs and certain related unfunded liabilities were included, Medicare and Medicaid administrative costs with the related unfunded liabilities were significantly higher (26.9 percent) than the private sector (16.2 percent).³

The New Study's Findings. We have taken a different approach this time. We are looking only at hard, or actual, administrative costs, and do not include the problems and potential costs incurred by Medicare's unfunded liability. Mark Litow, still with Milliman, has provided CAHI with a technical paper that identifies both Medicare's and the private sector's administrative costs; the technical paper is available on the CAHI website.⁴ This report explains in layman's terms what the technical paper found.⁵

Litow finds that Medicare's actual administrative costs, at 5.2 percent, are significantly higher than the oft-cited 2 percent. However, those costs are still lower than the private sector's administrative costs. There are several reasons for that, which will be discussed in more detail later in this paper.

In addition, the technical paper shows that average private sector administrative costs, about 8.9 percent, are significantly lower than the numbers frequently cited in the health policy community, although still higher than Medicare's. Large companies' administrative costs, which like Medicare achieve economies of scale, are even closer to those of Medicare.

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Even though the private sector's administrative costs are higher than Medicare's, that isn't "wasted money" that could go to insuring the uninsured. In fact, consumers receive significant value for those additional dollars.

We also raise an important, although heretofore unrecognized, issue that gives Medicare an inherent advantage on administrative costs. Medicare calculates administrative costs as a ratio of identified administrative costs divided by claims. 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 of 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, albeit unintentionally, *appear* to be lower than they really are. Indeed, if the numbers were adequately "handicapped," they would be in the 6 to 8 percent range, as we show later.

Finally, hard administrative costs are only part of the story. Anyone familiar with business knows that private firms must raise capital, usually by selling stock or borrowing money, and pay commissions. Obtaining those funds creates a liability for the company. Medicare doesn't incur those costs and so inherently is less costly to administer, right?

Medicare also has to obtain funds to pay claims. But the cost of raising that money, or borrowing it if the government doesn't collect it from taxpayers, is excluded from Medicare administrative cost calculations. While we don't in this paper draw any conclusions about what we shall call the "cost of capital" and its impact on Medicare's administrative costs — as CAHI did in the 1994 study — we do want to highlight that those costs exist and that taxpayers, both today and in the future, must bear those costs.

Medicare's Hidden Costs

Central to this study is the recognition that there are more costs in running the Medicare program than just paying claims — costs that are regularly included, and are more transparent, in any private sector assessment of administrative costs. For example:

Company Policies — Executives and boards of directors consider, debate and decide company policy; in Medicare that function is often handled by Congress and its legislative staff. Setting program policy requires time and money not reflected in Medicare's official administrative cost estimates. Just imagine all of the congressional and administrative staff time and effort devoted to creating, debating, promoting, opposing and ultimately passing the Medicare Modernization Act of 2003. One might compare it to a huge new corporate venture or restructuring. Yet not a dime of the money and time spent on that months-long public debate appear in Medicare's administrative costs.

Management — Businesses must include management costs in their administrative costs: Medicare doesn't. The salaries of those professionals at the Centers for Medicare and Medicaid Services (CMS), from Dr. Mark McClellan down, are excluded from Medicare's administrative cost estimates, as are the building costs to house that part of the leadership team. Private insurers don't have that luxury.

Raising Capital — Private industry has to raise capital, usually by selling stock or borrowing funds. And if an insurance company borrows money to pay for a building, it

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"While Medicare's 'cost of capital' is big now, it will grow exponentially in the future."

must pay interest on the loan. In other words, in the private sector there is a cost of capital.

Of course, the federal government also raises capital and borrows money to pay Medicare claims, and it even pays itself interest on some of that borrowed money.

But it includes none of these costs in its administrative estimates; it simply takes (or will take) the money from taxpayers. And while Medicare's "cost of capital" is big now, it will grow exponentially in the future as Medicare outlays grow faster than the Part A payroll tax.

Premiums and Commissions — One of the most common complaints is that the private sector has to pay agents to market and sell its products, which, critics contend, the government doesn't have to do.

Well, not exactly. You may have noticed that CMS has been heavily involved lately in promoting the new Medicare drug benefit. Nothing wrong with that, but those are marketing costs, which are ignored in Medicare's administrative numbers.

Premiums are the primary way private insurers obtain the funds they use to pay claims. But the government also has to bring in funds in order to pay Medicare claims. How does it do that? Through taxes. Employers, the IRS and the Social Security Administration are, in effect, the sales force and collection arm for the Medicare program. Workers and employers currently split the 2.9 percent payroll tax that funds Medicare Part A. Employers, of course, have to handle the administrative functions of getting that money to the government. Thus, that part of Medicare's "premium collection" actually shows up in *employers' administrative costs* — including, ironically, those of insurers collecting that 2.9 percent for the government — rather than Medicare's.

Revenue to pay the government's share of Part B — 75 percent of the program's costs — comes from general revenues collected by the IRS. And the Social Security Administration collects the 25 percent of the Part B program that comes from seniors' Social Security checks. Yet again, those "collection costs" are ignored in Medicare administrative cost estimates.

Claims Processing and Fraud — Medicare pays claims, millions and millions of them. The claims volume is so heavy that there is little time to do anything else — like scrutinize and review the providers' bills, check with providers if something looks amiss and withhold payment until discrepancies have been resolved.⁶ Rather, Medicare is set up to catch problems primarily in cases of massive fraud and abuse, and it does that through the Inspector General in the Department of Health and Human Services, not CMS. In other words, while insurers see claims oversight as responsible stewardship and a collaborative effort to ensure proper payment, HHS [operates](#) more as a policing effort.⁷

Premium Taxes — Every state imposes a tax on premiums collected, usually running in the 1 to 3 percent range.⁸ Those taxes are factored in as part of a company's administrative costs. Obviously Medicare has no equivalent. But it highlights the point that part of the insurance industry's administrative costs are not because the private sector is inefficient, but because government is taxing it and imposing regulations and unfunded mandates (that is, it tells the private sector to do something, but doesn't reimburse its costs). There is something a little disingenuous about imposing unwanted taxes and regulations on an industry and then criticizing it because its administrative costs are higher than the untaxed government program.

Are Low Administrative Costs Necessarily Good? At the heart of the debate over Medicare administrative costs is the assumption that low administrative costs are necessarily good. But is that a valid assumption?

We all know parents who spend very little time or effort raising and teaching — what we sometimes refer to as “parenting” — their children. Indeed, some parents simply acquiesce to whatever a child demands so they don’t have to expend the time and energy it takes to teach the child patience or the right thing to do.

Those parents have what we might call “low administrative costs.” And yet society frowns on those who don’t put forth the time and effort it takes to raise children properly.

Administrative Costs Can Add Value. Some activities that may raise administrative costs may also improve the quality of care. The private sector, for example, implements policies such as disease management that are intended to lower health care provider costs and improve outcomes.

Moreover, unlike Medicare, private insurers prefer the ounce-of-prevention approach. They scrutinize individual provider claims much more closely, challenge questionable procedures and determine whether, in the company’s opinion, a claim is valid or needs to be reconsidered. Indeed, one of the criticisms from the medical community is that some insurers take this responsibility too seriously (or even abuse it), frequently resulting in late, reduced or denied payments.

The point is that private insurers are much more diligent in scrutinizing claims. That financial stewardship adds to administrative costs; it also lowers claims costs (thus, doubly adversely affecting the private sector’s administrative cost ratio). The government, by contrast, is a claims-paying machine. When abuse becomes egregious, the fraud unit steps in — and that effort won’t be included in administrative costs.

While everyone wants health insurance administrative costs to be as low as possible, that should mean as low as possible while still adequately adjudicating claims to ensure that insurers are paying only what they should. Medicare doesn’t do that. As a result, Medicare is paying claims it shouldn’t — *and, ironically, making its administrative cost ratio look more favorable!*

Hidden Costs Are Still Costs. Just because the government doesn’t reflect all of the various costs of doing business in its official estimates of Medicare administrative costs, that doesn’t mean they don’t exist. Or that taxpayers don’t pay those costs. They do. A hidden cost is still a cost, even if taxpayers don’t know they are paying it.

"Private insurers are much more diligent in scrutinizing claims."

What Are Included in Administrative Costs?

The comparisons found in this paper reflect all administrative costs consistent with a functional cost analysis. In making our comparison, we consider all administrative functions that are part of general government overhead but related to Medicare. Under private insurance, we have addressed administrative expenses both with commissions, premium taxes and profits, and without them.

- ◆ For Medicare, we include not only reported costs, but a proportional allocation of all overhead costs for functions where people spend time on Medicare, costs not allocated to Medicare by the government. Medicare unreported costs include parts of salaries for legislators, staff and others working on Medicare, building costs, marketing costs, collection of premiums and taxes, and accounting, including auditing and fraud issues, etc. These are currently included in the federal budget in various areas such as legislative, judicial, and Health and Human Services but not specifically earmarked to Medicare.
- ◆ For private insurance, we include all functional costs, although results in this report are shown both with and without commissions, premium taxes and profits. The exclusion of these items could be considered more comparable from the standpoint that government does not incur commissions for selling, pay any profits to shareholders or policyholders, nor does it have to pay premium taxes or other taxes for that matter. Private market administrative costs do include acquisition costs over and above commissions, such as underwriting and advertising, where applicable, but investment income is not included. Private insurance costs are estimated separately by the individual, small group and large group markets and averaged together. Large group includes self-funded plans. For both Medicare and private insurance, administrative costs in all cases reflect those for adjudicating and paying claims, record keeping and various types of analysis and management. Overhead refers to other items such as building costs, personnel costs, etc.

The estimates of Medicare administrative and overhead costs are based on our examination of the federal budget and our judgment based on experience in working with various parts of the Medicare program. For private insurance, our estimates are based on various data sources, our research as used in our modeling of United States health care reforms, our experience and judgment.

The results do not represent the input or opinions of any of the organizations which provided financial support. Similarly, while the results presented reflect discussions we have had with a number of actuaries and consultants within Milliman in the course of our work, they represent our personal opinions and not those of Milliman.

Mark Litow
Milliman, Inc.

Identifying the Costs

The federal government relies on various administrative, borrowing, funding, collecting and accounting functions. Most of these are not captured in the official Medicare administrative cost estimates, and some actually have no counterpart in the private sector.

Private Sector: For private insurance, this report includes all functional costs from national health care expenditure data and Milliman data. These costs always include acquisition costs over and above commissions, such as underwriting and advertising, where applicable, but investment income is ignored. However, results in this report are shown both without and with commissions, premium taxes and profits.

Medicare: All Medicare administrative costs are determined in this study via a functional cost analysis, which includes not only reported costs from the federal budget and the Medicare trustees' report, but also a proportional allocation of all overhead costs for functions where people spend time on Medicare. The report splits such Medicare costs into reported and unreported costs.

For both Medicare and private insurance, administrative costs in all cases reflect those for adjudicating and paying claims, record keeping and various types of analysis and management. Overhead refers to other items such as building costs, personnel costs, etc. There is, of course, a subjective element to this allocation because costs are estimated from other parts of the federal budget. But this report has tried to be conservative in its calculations so that if it errs, it would err on the low side.

Results: When only administrative costs are compared, the government comes out somewhat lower. Pure administrative costs for Medicare are not as low as the government reports because Medicare excludes several important components. When they are included, we calculate Medicare's administrative costs to be 5.2 percent in 2003, while the private sector runs 8.9 percent when commissions, profit and premium taxes are excluded, and 16.7 percent when those factors are included. [See Table 1.]

"This report has tried to be conservative in its calculations so that if it errs, it would err on the low side."

Table 1 Fiscal Year 2003 Administrative Cost For Medicare and the Private Market (millions of dollars)	
Medicare	
i) Acquisition/Administration/Overhead Costs Reported	\$5,168
ii) Acquisition/Administration/Overhead Costs Unreported	9,837
iii) Total of i and ii	15,006
iv) Medicare Claims (benefits paid)	272,707
v) Sum of iii and iv	287,713
vi) Administrative Cost Percentage for Medicare	5.2%
Private Market	
Expenses as a % of private market premiums (no commission, premium tax or profit)	8.9%
Total expenses including commission, premium tax and profit	16.7%

Note: Medicare percentages are presented as a ratio of administrative costs to the sum of claim payments and administrative costs. Private health market expenses are expressed as a ratio of administrative costs to premiums paid. The reason premiums are used in the private market is that they consist essentially of claims and administrative costs, thus it is the same measure as used for Medicare.

Deriving Medicare’s Administrative Costs. First, it should be understood that the administrative cost percentage (i.e., 5.2 percent for 2003) is derived by dividing the amount of reported and allocated Medicare administrative expenses (\$15 billion) by the total money spent by the program (\$287.7 billion).

$\frac{\text{Administrative Costs}}{\text{Medicare Claims}} = 2\%$	$\frac{\text{Lower Admin Costs}}{\text{Higher Claims}} = \text{Better Ratio}$
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When Medicare was enacted in 1965, the administrative costs were much higher, about 17 percent. That percentage has declined over the years, as will be explained below. Private sector administrative costs, by contrast, have shown relatively small changes — no more than 1 to 2 percent — at least in recent years.

As Congress expanded Medicare eligibility to other populations besides seniors, and as utilization exploded because seniors were largely insulated from the cost of care, the denominator (i.e., claims — the \$287.7 billion) has grown faster than the numerator (i.e., administrative costs — the \$15 billion). In Table 2 are estimates of the administrative costs as a percentage of Medicare payments (real and estimated) for selected years from 1967 through 2025, including those factors usually excluded by Medicare.

Table 2						
Estimated Administrative Cost Under Medicare 1967-2025						
Relative to Total Medicare Costs						
(billions of dollars)						
	1967	1985	2003	2010	2017	2025
i) Medicare estimated administration cost	\$0.6	5.4	15.0	18.2	22.4	28.4
ii) Total Medicare Payments	\$3.2	69.5	272.7	528.7	911.9	1700.5
iii) Percentage (i)/i+ii)	17.0%	7.2%	5.2%	5.3%	2.4%	1.6%

Is Medicare Getting More “Efficient”? Based on Tables 1 and 2, one can see that the administrative cost figure for Medicare has been decreasing and is estimated to continue downward — making Medicare look as if it is getting even more “efficient” as time passes. Higher costs in early years were partly due to startup program costs — which private insurers also have — but the primary reason for the decrease is clearly the acceleration in Medicare benefits (averaging about 8 percent growth per year) versus the estimated increase in program administrative costs (about 3 percent per year).

Using Table 2 as a basis, even with the unreported costs (see Table 1, Medicare ii), Medicare over time looks better and better relative to the private market because private administrative costs will likely remain roughly the same as a percentage of claims. Why are benefits growing faster than administrative costs? There are at least two reasons: increased economies of scale and the high, and growing, cost of treating seniors.

Private Sector Economies of Scale. Certainly one reason for Medicare’s declining percentage of administrative costs is greater economies of scale, but the private sector

"Medicare over time appears more efficient relative to the private market because Medicare claims are growing so rapidly."

also can achieve economies of scale. Large employers have lower administrative cost ratios than small employers, and not much more than Medicare.

Table 3 shows the percentages for administration, including overhead, with and without commission, premium tax and profit (none of which Medicare pays). As the table shows, large group administrative costs are significantly lower than the individual and small group market — approaching Medicare’s true administrative costs, even though Medicare is a much larger program.

Table 3				
Estimated Private Market Expenses (percent of earned premium)				
Market	(Profits)	Admin without Commission, Premium Tax and Profit	Commission and Premium Tax	Total Admin
Individual	3.0%	12.5%	14.5%	30.0%
Small Group	2.0%	10.5%	10.5%	23.0%
Large Group	2.5%	8.0%	2.0%	12.5%
Composite Private	2.5%	8.9%	5.3%	16.7%

These private market estimates will vary considerably from company to company. However, private organizations in certain markets are required to return at a minimum a certain amount of premium in benefits. This percentage for medical plans can be as low as 55 percent (guaranteed renewable hospital indemnity plans) and in some cases may exceed 100 percent (group conversion policies). However, in general, companies will return 80 to 85 percent on average to consumers in the form of health care benefits, which is the reverse way of saying that their administrative cost expense is about 16.7 percent.

The Underlying Distortion in Medicare’s Administrative Cost Ratio. As stated earlier, Medicare arrives at its administrative cost ratio by dividing the amount of money reportedly spent on administration by the amount of claims paid. Unfortunately, that approach gives Medicare an unfair advantage. That’s because Medicare serves the senior population, while comprehensive private insurance policies target the under-65 population. Seniors spend, on average, more money on health care than those under 65. As a result, the average claim paid in Medicare is higher than that for those under 65.

To use an easy example, suppose the average claim for a senior is \$2,000, while the average claim for a person under age 65 is \$1,000. And suppose that the cost to administer both claims is \$100. In this scenario, the administrative cost ratio for the private sector would be 10 percent, but only 5 percent for Medicare. In other words, even if the administrative costs are exactly the same in Medicare and the private sector, Medicare will look more efficient because the average claim is larger. How much larger?

"Because Medicare serves the senior population, its administrative cost ratio has an advantage."

\$100 Admin Costs	=	

\$ 1,000 Claims		= 10% Admin Cost Ratio
\$100 Admin Costs	=	

\$2,000 Claims		= 5% Admin Cost Ratio

For medical costs only, excluding out-of-pocket spending, in 2003:

- Medicare spent \$6,600 per person.
- The private sector spent only \$2,700 per person.
- That means that average per-person claim in Medicare is more than twice the average per-person claim in the private sector.

So how does that affect the administrative cost ratio? The Milliman report concludes that when the relevant administrative costs are included in Medicare, the ratio is about 5.2 percent. If the numbers were adequately “handicapped” for comparison with the private sector, *the Medicare administrative cost ratio would be roughly 6 to 8 percent.*

And there are other distortions that could affect the ratio. For example, Medicare deals with each senior separately; there are no family policies in Medicare. Not so in the private sector, where a large percentage are family policies. Why does that make a difference? Because the private sector bundles the premiums in a family policy. The cost of a four-person family policy will be significantly less than if all four were rated separately. That practice reduces the total premium received, but has no effect on ultimate claims costs — which negatively affects the administrative cost ratio.

The point is that even if the numbers show Medicare’s administrative cost as lower than the private sector, *variations such as higher average per-person claims could vastly underestimate Medicare’s true administrative costs.*

Higher Administrative Costs Don’t Necessarily Mean Unaffordable Policies. Do higher administrative costs in the private sector mean that those policies are a bad deal?

Not at all. In fact, in many states policies sold in the individual market are *more* affordable than the small or large group markets.⁹ And that’s in part because state and federal laws and regulations can have a much bigger impact on the cost of a policy than administrative costs.¹⁰

For example, federal law requires small group policies to be guaranteed issue (i.e., an insurer must accept any applicant, regardless of health condition). That one regulation has been one of the primary factors behind the explosion of premiums in the small group market. Eight states imposed guaranteed issue and community rating (everyone is charged the same price) on the individual market. Health insurance policies in those states that have kept the guaranteed issue provision cost much more than policies in most other states.¹¹

The lesson to be learned: Lower administrative costs are good, but they can be undermined by harmful laws imposed by Congress and the states.

Medicare’s Funding vs. Premiums and Commissions. But even if Medicare’s administrative costs are not significantly less than the private sector’s, isn’t it still a better deal since there are no commissions and profits?

Not necessarily. Both private insurers and the Medicare program have to obtain the funds to pay claims. Insurers must be transparent in how they acquire, allocate, invest and disburse those funds. Not so with Medicare.

Medicare obtains its funds to pay claims in several ways. First, it imposes a 2.9 percent payroll tax on all income, paid half by an employer and half by the employee.¹²

While private insurers have to pay commissions to bring in premiums, Medicare forces employers to collect and process its “premiums.” Those collection efforts show up in

"In many states policies sold in the individual market are very affordable."

"Medicare also collects 'premiums,' but imposes those collection costs on the private sector and other government agencies."

employers' administrative costs, not Medicare's. Those payroll tax funds are deposited into the Medicare Health Insurance (HI) Trust Fund, known as Medicare Part A, which primarily pays hospital claims.¹³

Second, Medicare also has a Supplementary Medical Insurance (SMI) Trust Fund that covers physicians' costs, widely known as Medicare Part B. Although this program is voluntary, the vast majority of seniors choose to join it when they turn age 65. One-quarter of the program is funded by a monthly premium, \$88.50 per beneficiary in 2006, which is deducted from seniors' Social Security checks.¹⁴ The other three-quarters of Part B is funded out of the federal government's general revenues (that is, revenue from current taxpayers).

Finally, the Medicare trust fund operates on a pay-as-you-go basis. Money collected from the payroll tax is paid out in current claims. For most of its 40 years, the Part A trust fund has taken in more in payroll taxes than it paid out, producing, at least on paper, a surplus in the account. However, the federal government borrows that money and uses it for funding other expenses. So there are no hard assets in the Part A trust fund, only IOUs from the federal government.

In addition, the government pays the trust fund interest on that borrowed money. But that is just an accounting function; the government doesn't actually transfer dollars in the fund.

Part B, by contrast, draws on federal revenues. In 2004, Medicare beneficiaries paid \$31.4 billion in premiums and \$100.9 billion came from general revenues.¹⁵

How much do all of those Medicare taxes, collection efforts and interest *really* cost? We don't answer that in this study, but it's a lot. And when added on to an accurate calculation of Medicare's administrative costs, it is very hard to claim that Medicare is more efficient than the private sector.

Conclusion. Medicare at first glance appears to have lower administrative costs than the private sector. But there are several caveats that make untenable an easy comparison between Medicare and the private sector — as private sector critics like to do. Most of what are considered administrative costs in the private sector are not captured by official Medicare accounting. So the investigators in this study tried to estimate how much it would be from other parts of the federal budget.

Second, there is an assumption that administrative costs are bad. The fact is that only *inefficient* administrative costs are bad. Insurers regularly scrutinize claims forms and check with health care providers if they find an error, discrepancy or what they believe to be an unnecessary treatment. That raises administrative costs, but it also lowers claims costs. That is a benefit for those insured because it helps keep premiums lower.

Moreover, that regular scrutiny has an impact on providers' behavior, helping to discourage the small percentage who might try to game the system to increase their income. In other words, efficient administrative oversight alters behavior, and the cost is almost certainly recovered in lower premiums.

Finally, because Medicare on average pays out more per claim, it distorts the administrative cost ratio. If both the private sector and Medicare paid out roughly the same on a per-claim basis, private sector hard administrative costs would likely be close.

However, the issue is not and should not be which segment, private sector insurers or government-run plans, has the lowest administrative costs. The issue should be which

does the best job of providing quality health insurance coverage for the best price. When one looks at all of the money pouring into Medicare, even with the price controls imposed by the government, the answer has to be the private sector.

APPENDIX

Methodology

The calculations shown above are based on the methodology as described here.

- ◆ **Medicare Administrative Costs:** This represents reported costs of administration as given in the Federal budget plus an estimate of unreported administrative costs based on a functional analysis of Federal budget costs related to fiscal year 2003.
- ◆ **Private Market Administrative Costs:** This is based on our experience and judgment. All administrative costs include allocations of overhead.

Assumptions Used

- ◆ **Administration for Years Other Than 2003:** In estimating administrative costs for years prior to 2003, we used actual reported costs for 1965 through 2003. For unreported costs from 1965 through 2003, we used the ratio of unreported costs to reported costs for 2003 and applied this percentage to the reported costs in those years to estimate the unreported costs. For years subsequent to 2003, we used government projections as available through 2009, and a 3% trend thereafter, consistent with government trends from 2003 through 2009.
- ◆ **Projections of Medicare and Federal Expenditures:** Based on government estimates through 2009 (using estimates at the close of fiscal year 2003) and projected annual increases after 2009 as applied to fiscal year 2009. These increases are consistent with the annual increases estimated for 2003 through 2009, unless otherwise noted:
 - a. Total federal expenditures: 5% annual increase for all expenditures
 - b. Administrative expenses: 3% annual increase
 - c. Medicare claims: 8.1% annual increase

Table 4			
Calculation of Medicare Administrative Costs			
(in millions)			
	2003	Allocation of Federal to Medicare Expense	Assumed Allocation Percentages
Total Federal Budget	\$2,157,637		
Medicare Benefits	266,890	\$5,168	Non-allocated, direct expenses
Medicaid Benefits	160,700		
Other Health	58,883		
Allocated Administration	10,976	5,504	50.1%
Executive/Legislative	22,987	3,344	14.5%
Judicial (non-correctional)	6,804	990	14.5%
Total	NA	\$15,006	

Source: The Budget of the United States Government Fiscal Year 2005 and our judgment

Table 5				
Private Industry Assumed Expense Summary by Market and Function				
Administrative Costs by Market	Individual	Small Group	Large Group	Total as a % of Earned Premium
Overhead, Miscellaneous	2.0%	2.0%	1.0%	1.3%
Issue Underwriting	3.0%	1.5%	1.0%	1.3%
Actuarial	1.0%	1.0%	0.5%	0.7%
Record Keeping, Policy Service, Compliance	1.5%	1.5%	1.0%	1.2%
Claims	3.0%	3.0%	3.5%	3.3%
Development, Eligibility, and Enrollment Subtotal	10.5%	9.0%	7.0%	7.8%
Commission	12.5%	8.5%	1.0%	4.0%
Marketing (non-commission)	2.0%	1.5%	1.0%	1.2%
Profit	3.0%	2.0%	2.5%	2.5%
Selling & Cost of Capital Subtotal	17.5%	12.0%	4.5%	7.6%
Total (excluding taxes)	28.0%	21.0%	11.5%	15.4%
Premium and Other Tax	2.0%	2.0%	1.0%	1.3%
Total (as a % of earned premium)	30.0%	23.0%	12.5%	16.7%
Total Without Commission, Premium Tax & Profit	12.5%	10.5%	8.0%	8.9%

Table 6				
Private Industry Expense Summary by Market and Function				
(billions of dollars)				
Administrative Costs by Market	Individual	Small Group	Large Group	Total
(A) Health Costs Only	\$44	\$110	\$323	\$477
(B) Costs Covered by Insurance (%)	80.0%	85.0%	90.0%	88.0%
(C) Total Covered Costs (A) x (B)	\$35	\$93	\$291	\$419
Total (as a % of premium from Table - 3)	30.0%	23.0%	12.5%	17.0%
(D) Total Premium [1 – total (as a % of premium from Table 3)]	\$50	\$122	\$332	\$504
(E) Administrative Costs (D) – (C)	\$15	\$29	\$41	\$85

Source: EBRI, Statistical Abstract, Milliman Health Cost Guidelines, our judgment

Notes

¹To take a popular example, when the NBC series “The West Wing” broadcast its live “presidential debate” (Nov. 6, 2005) between Democratic candidate Rep. Matt Santos (Jimmy Smits) and Republican candidate Sen. Arnold Vinick (Alan Alda), Santos claimed that the private sector spent 25 percent of revenue on administrative cost, while Medicare spent only 2 percent.

² See, for example, the U.S. General Accounting Office (now the Government Accountability Office): “If the U.S. were to shift to a system of universal coverage and a single payer, as in Canada, the savings in administrative costs [10 percent of health spending] would be more than enough to offset the expense of universal coverage.” “Canadian Health Insurance: Lessons for the United States,” ref no: GAO-T-HRD-91-35, June 4, 1991.

³ “Rhetoric vs. Reality: Comparing Public and Private Health Care Costs,” Mark Litow and CAHI’s Technical Committee, Council for Affordable Health Insurance, 1994.

⁴ The study is entitled “Medicare vs. Private Health Insurance: The Cost of Administration” and can be found at www.cahi.org.

⁵ While the views of this report are the Council’s, we have tried to accurately represent the paper prepared by Mark Litow and have had our conclusions reviewed by him to ensure that we have not misrepresented his findings. In some cases, we pull directly from the original study. Nevertheless, the reader is encouraged to examine the original paper for further detail and discussion of the methodology.

⁶ Several years ago I was quoted in a *Reader’s Digest* article on Medicare saying that because Medicare insulates seniors from most of the cost of health care, they are less concerned about what the bills actually cost. I received about a dozen calls from seniors across the country who let me know that they had noticed that the doctor or hospital had charged Medicare for something they did not receive, and that they had called Medicare to say the bill shouldn’t be paid. Every one of those seniors told me that Medicare’s response was not to worry about it, the bill had been paid anyway.

In addition, we have a personal friend who received a copy of a Medicare bill for her husband—a year after he had passed away. She called Medicare but was told the bill had already been paid. The typical private sector insurer would have caught that discrepancy.

⁷ The Office of Inspector General at HHS publishes a semiannual report detailing the department’s efforts. According to the one released in December 2005, covering April 1 to Sept. 30, 2005:

“For fiscal (FY) year 2005, the Office of Inspector General (OIG) reported savings and expected recoveries of nearly \$35.4 billion: \$32.6 billion in implemented recommendations and other actions to put funds to better use, \$1.2 billion in audit receivables, and \$1.6 billion in investigative receivables.

“Also for this fiscal year, OIG reported exclusions of 3,806 individuals and entities for fraud and abuse of Federal health care programs and/or their beneficiaries; 537 criminal actions against individuals or entities that engaged in crimes against departmental programs; and 262 civil actions, which include False Claims Act and unjust enrichment suits filed in district court, Civil Monetary Penalties Law settlements, and administrative recoveries related to provider self-disclosure matters.” (<http://oig.hhs.gov>)

⁸ Litow uses a 2 percent estimate for premium taxes.

⁹ For example, go to ehealthinsurance.com, put in some information about yourself, including zip code, and people in most states will see a wide range of policies with varying deductibles, copays, coverages and prices.

¹⁰ For example, state-mandated benefits can significantly increase the cost of a health insurance policy. See “Health Insurance Mandates in the States: 2005,” Council for Affordable Health Insurance, January 2005.

¹¹ For a full discussion of the impact of guaranteed issue and community rating on those states, see Conrad F. Meier, *Destroying Health Insurance Markets: How Guaranteed Issue and Community Rating Destroyed the Individual Health Insurance Market in Eight States*, Council for Affordable Health Insurance and The Heartland Institute, 2005.

¹² While the Medicare payroll tax is on all earned income, the 12.4 percent payroll tax that funds Social Security applies to only the first \$94,200 of earned income in 2006.

¹³ When people talk about the financial solvency of Medicare, they are usually referring to the Part A trust fund, ignoring the federal funds required for Part B.

¹⁴ “2005 Annual Report of the Board of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds,” March 23, 2005, Table III. C6, p. 82. The Medicare Part B premium for 2006 is \$88.50 per month. Premiums for the disabled are higher.

¹⁵ *Ibid.*, Table III. C1, p. 74.