

**Medicare versus Private Health Insurance:
The Cost of Administration**

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I. EXECUTIVE SUMMARY

This study compares the administrative costs of Medicare to those for the private insurance industry on average. 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.

Medicare covers around 42 million individuals with one program which should provide it significant economies of scale. The private under age 65 market covers around 165 million individuals through hundreds of companies, suggesting much less ability to create economies of scale.

The Federal government usually reports its Medicare administrative costs at about 2% of total payments under the program while private costs vary dramatically from market to market, but frequently are cited to be in the 15-20% range on average.

This report discusses how administrative costs have changed over time, what the actual estimates in each case appear to be, and what is likely in the future.

Executive Summary - Results

The following chart summarizes estimated administrative costs under Medicare versus private insurance for years 2003, 2010 and 2025; note that private insurance costs as a percentage of total costs are expected to remain constant. 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 cost 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. Bullets following the chart provide a summary of the most salient findings. Other results are shown later in the report.

	Medicare						Private Health Market	
	1967	1985	2003	2010	2017	2025	No commission, premium tax, profit	With All Expenses
Costs as a Percentage of Claims plus Expenses								
Administrative	17.0%	7.2%	5.2%	3.3%	2.4%	1.6%	8.9%	16.7%

The results from our tests can be summarized as follows:

- ◆ Administrative costs are lower under Medicare than for private health insurance, although Medicare costs are higher than reported in the Federal budget and private costs are not dramatically higher than Medicare once non-comparable costs (commissions, premium tax and profit) are removed. Our best estimates indicate Medicare at slightly above 5% of total Medicare cost in 2003, whereas the government currently reports about 2%.
- ◆ Medicare administrative costs decrease because Medicare benefit costs increase at a higher rate than administrative cost increases. Benefit costs have typically been about double normal inflation (CPI increases) whereas administrative costs typically increase near the CPI rate.
- ◆ The private market administrative costs are expected to remain at about 9% of total private insurance cost, excluding premium taxes, commissions, and profit. With such items, private costs would be slightly under 17%. While we have not studied private costs at various points in time, a look at costs in the early 1990s indicated administrative costs at roughly the same level, although there have been changes in certain markets.
- ◆ Administrative costs for Medicare versus private health insurance are not the only consideration in comparing these two forms of insurance protection. Liabilities accrued can create issues just as significant as costs, whether they are funded or not. This topic is beyond the scope of this paper but is considered in a separate paper.

In comparing Medicare and private market administrative costs, the risk covered and the size of the population should be taken into consideration. The average annual cost per person under Medicare is more than double that under private health insurance. In 2003, the average medical cost for Medicare is estimated to be about \$6,600 per person per year, while the average medical cost for private health insurance, excluding out-of-pocket cost is \$2,700 per person per year. Further, Medicare covers 42 million people versus numerous private insurers/employers covering a total of about 160 million people. If Medicare's

claim costs were the same as in the private market, Medicare's administrative costs would increase to perhaps 6-8% of administrative costs and claims.

In this report, we have examined the administrative cost on a best estimate basis only. Medicare costs in this report 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 our experience and judgment.

The following sections of this report provide an introduction to our analysis, summary of findings, and methods used to arrive at the conclusions.

II. INTRODUCTION

At the request of the Council for Affordable Health Insurance, Milliman has undertaken this study to provide a comparison, to the extent possible, of Medicare and private health insurance administrative costs relative to the sum of benefit payments and administrative costs under each. Our analysis focuses on the present and future anticipated results under each, using the past as a guide.

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

- ◆ For Medicare, administrative cost includes not only reported costs but a proportional allocation of all overhead costs for functions where people spend time on Medicare but are 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, 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 are not specifically earmarked to Medicare.
- ◆ For private insurance, administrative costs include all functional costs, including commissions, premium taxes and profits, although results in this report are shown both without and with 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 ignored. Private insurance costs are estimated separately for the individual, small group and large group markets and averaged together. Large group includes self-funded plans.
- ◆ For both Medicare and private insurance, administrative cost includes 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.
- ◆ For Medicare, administrative cost reflects coverage on an individual basis. For private health insurance, administrative cost reflects coverage on either a single or

family basis; coverage on a family basis will tend to reduce administrative cost percentages somewhat.

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 such as National health care expenditure data, our research as used in our modeling of United States health care reforms, our experience and judgment.

The results in this report do not necessarily 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.

The following sections of this report present a summary of our findings, a description and discussion of the methodology used, and details underlying the results and conclusions.

Milliman is an independent organization which provides consulting services related to health care financing and management to a wide variety of clients throughout the United States. Milliman provides consulting services in other major specialty areas which include life insurance, property/casualty and pension and related employee benefits.

This report should be used in its entirety. Portions may not be excerpted. Any reader of this report should have appropriate background in analyzing financial and insurance values or receive counsel from an appropriate advisor with such skills.

III. SUMMARY OF FINDINGS

Our comparison of Medicare versus private health insurance administrative costs shows that Medicare does indeed have lower administrative costs as a percentage of total costs (benefits paid plus administrative costs).

Table 1 shows Medicare administrative funded costs relative to Medicare dollars for Fiscal year 2003 and compares it with private health insurance estimated funded costs in that same period. In other words, Medicare administrative estimates are as they appear in the Federal budget, or as estimated consistent with that basis. Private market estimates in this table are based on the percentages as shown later in this report.

Table 1	
Fiscal Year 2003 Administrative Cost	
For Medicare and The Private Market (dollars in billions)	
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%

In Table 2, we estimate the administrative costs under Medicare for selected years from 1967 through 2025, as a percentage of estimated Medicare payments. These estimates compare to a flat percentage of 8.9% for private health insurance, as estimates have shown small movement in these numbers in at least recent years (no more than one to two percent).

Table 2						
Estimated Administrative Cost Under Medicare 1967-2025						
Relative to Total Medicare Costs (dollars in billions)						
	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	\$1,700.5
iv) Percentage (i)/i + ii)	17.0%	7.2%	5.2%	3.3%	2.4%	1.6%

Based on Tables 1 and 2 one can see that the administrative cost of Medicare has been decreasing and is estimated to continue downward. Higher costs in early years are partly due to startup costs, but other than that the reason for the decrease is clearly the acceleration in Medicare benefits versus the estimated increase in administrative cost. This similar pattern is not observed in the private market because it tries to maintain affordability by periodically increasing cost sharing. In this manner, private market premium coverage adjustments tend to increase more closely with wage growth and the consumer price index (CPI) than health costs do. Using Table 2 as a basis, even with the unreported costs, Medicare over time looks better and better relative to the private market with its estimated roughly flat percentage. The reason for the continued rapid decrease after 2003 is that expenses are assumed to inflate at roughly 3% per year while Medicare benefits/cost expand at roughly 8% per year.

Private market costs as a percentage of premiums vary substantially by type of market primarily because marketing methods are necessarily different. The range by broad market type is shown in Table 3. Percentages are shown for administration including overhead, with and without commission, premium tax and profit (Medicare does not have to pay commission, premium tax and is not a for profit venture). These estimates are based on our knowledge and judgment. We did not adjust the private market expense percentages to reflect paid rather than incurred claims because it would be immaterial, perhaps increasing the expense percentage by only 0.2%.

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 by regulation to return at a minimum a certain amount of premium in benefits. This percentage for medical plans can be as low as 55% (guaranteed renewable hospital indemnity plans) and in some cases may exceed 100% (group conversion policies). However, in general, companies will return 80% to 85% on average to consumers in the form of health care benefits, or the compliment of the 16.7% expense percentage. Table 9 includes details on the administrative and other costs (excluding morbidity) in the individual, small group and large group private markets.

IV. METHODOLOGY AND ASSUMPTIONS

A. 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.

B. 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 cost 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 Administration and Claim 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. Administrative Expenses: 3% annual increase
 - b. Medicare claims 8.1% annual increase:

V. HOW THE STUDY WAS CONDUCTED

This study compares the administrative costs only of Medicare and private health insurance relative to total costs in their respective markets. Costs were based on methods as described in Section IV. Government administrative costs represent federal expenditures under Medicare for paying claims, audit and peer review processes, proportional allocation of general costs within the Department of Health and Human Services, and an allocation of certain Executive Branch and judicial costs. Such allocations are based on assumptions made relative to the proportion of such costs in Medicare versus other costs within the Health and Human Services budget or the remainder of the Federal budget. Private administrative costs represent those of the insurance industry and employers for most private markets, including: individual, small group, large group, and self-funded plans for the under age 65 markets.

A. Administrative Cost Calculations

The cost allocations developed for government follow approaches used by business to appropriately assign expenditures to proper lines of business. The estimates as shown and developed in Tables 1 and 2 represent informed judgments based on available data.

Table 1 shows administrative cost for Medicare and private health insurance as a percentage of total dollars spent on benefits and administration. For private coverage, the denominator is either gross premiums without or with the impact of commissions, premium taxes and profits. “Administrative Costs Reported” represent all costs specific only to Medicare. “Administration Costs Unreported” reflect other estimated Medicare administrative expenses normally reported in general budget categories that are not specifically attributed to Medicare, even though we estimate they are part of the cost of administering Medicare.

Table 2 shows the estimate proportion of Medicare Administrative costs to total Medicare costs for selected years 1967 through 2025.

Table 3 shows estimated costs by private market.

Table 4 shows total Medicare administrative costs for fiscal year 2003. The expenses in this table are consistent with Tables 1 and 2. A portion of costs for other government departments is allocated to Medicare based upon the ratios of Medicare health care expenditures to total allocated government expenditures on a line by line basis within each department.

Tables 5 and 6 show administrative costs for the private insurance industry based on an aggregate of costs for all insurance expenses and profits. Expenses represent averages by

function across all markets. Total administrative expenses are estimated to be \$85 billion in 2003 dollars, compared to total premiums of \$504 billion. Out-of-pocket consumer payments of approximately \$58 billion are excluded.

All private industry costs are based on a national database developed by Milliman to reflect calendar year 2003. Total costs used in this analysis are very similar to those estimated by the Health Care Finance Administration.

B. Sensitivity Testing

In performing this study, we have examined the sensitivity of results to changing the assumption relative to unreported Medicare administrative expenditures and private expenditures. These tests indicated that a significantly greater variation in unreported costs or private costs would still likely result in Medicare expenses lower than the private market but with Medicare administrative costs significantly higher than currently reported by Medicare. Also, the percentage of Medicare Administration cost would likely still decrease as a percentage of total Medicare cost, without a significant decrease in Medicare trends or rise administrative cost trends.

Other sensitivity tests could have been tested, but none was likely to alter the basic conclusions that the size of Medicare produces some benefit related to Medicare Administrative cost alone, although not nearly as much as the government claims. Further, significant increases in benefit costs is helping to reduce the Medicare Administrative cost, but this is misleading due to the issues raised by increasing Medicare benefits/costs. A separate paper on Federal Budget liabilities created by Medicare examines this issue in part.

- ◆ Further, our analysis indicates that private insurance administrative costs have not changed much in recent years, and a swing of more than a few points in either direction seems unlikely at the present time. Certainly, private costs may vary substantially from one company to another, but our focus on this study was on aggregate costs. We did not go back and analyze private costs prior to the early 1990s but loss ratios, at least in the individual market before 1990 were lower, meaning higher administrative costs may have existed in this market.

Table 4			
Calculation of Medicare Administrative Costs (in billions)			
	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	0.990	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 Tablet 3)]	\$50	\$122	\$332	\$504
(E) Administrative Costs (D) – (C)	\$15	\$29	\$41	\$85
<i>Source: EBRI, Statistical Abstract, Milliman Health Cost Guidelines, our judgment</i>				