

A Time to Harvest: Evidence on Consumer Choice Frictions from a Payment Revision in Medicare Part D

In many federally-subsidized insurance markets, insurers' subsidies are tied to enrollee diagnoses via diagnosis-specific risk adjustment. Diagnosis-specific risk adjustment makes insurers indifferent between enrollees with different diagnoses by paying them the expected cost of treating each diagnosis. Over time, the expected cost of treating each diagnosis can change due to factors such as changes in available treatments, the price of treatment, or the typical treatment for a diagnosis, requiring any diagnosis-specific risk adjustment system to be periodically revised. This paper exploits a revision to Medicare Part D's risk adjustment that dramatically changed the payments for many risk adjustment diagnoses between 2010 and 2011.

This paper first shows how the mean insurer responded to the revision of diagnosis-specific payments. Consistent with prior theory, insurers improved benefit design generosity – i.e., reduced copays – for diagnoses receiving payment increases. Conversely, copays fell for diagnoses receiving payment decreases. Next, the paper develops a model of how, in the presence of choice frictions, enrollment in 2010 should affect an insurer's response to the payment revision. Suppose Medicare Part D enrollees exhibit high inertia or high switching costs (as previous research has suggested), and the payment revision causes the payment for a particular diagnosis to rise. An insurer who has a large share enrollees with that particular diagnosis will improve benefit design generosity *less* than an insurer with a small share of such enrollees. Intuitively, the insurer with a large share must finance the improved benefits for all their (inert) current enrollees, while facing a limited ability to obtain larger market share; meanwhile, current enrollees are “locked in” to the insurer with the large share and will not switch towards the improved benefits offered by the small insurer. I find evidence consistent with the predictions of the theoretical model. This analysis provides indirect evidence of the presence of demand-side choice frictions using only supply-side behavior.