Plan switching and inertia in Medicare Part D: Evidence from administrative data

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The recent trend towards giving consumers more choice about their health plans has invited research on how good individuals are at making these decisions. The introduction of Medicare Part D is an important example. Initial plan choices in this market were generally far from optimal. In this paper, we focus on plan choice in the years after initial enrollment. Due to changes in plan supply, consumer health status, and prescription drug needs, consumers´ optimal plans change over time. However, in Medicare Part D only about 10% of consumers switch plans every year, and the cost implications of earlier plan choices worsen for those who do not switch. High rates of inertia – the unwillingness or inability to switch to a better plan when circumstances change – have also been observed in other markets. The factors that drive the high rates of inertia, however, are largely unexplained.

In this paper, we develop a two-stage panel data model of plan choice whose stages correspond to two separate behavioral mechanisms that lead to inertia: inattention and (tangible) switching costs. Our model allows for unobserved heterogeneity that is correlated across the two decision stages. We argue that unobserved heterogeneity reflects individual diligence in plan choices – among other things, heterogeneity in the ability to choose health plans as well as carefulness in the decision. In our model, the latter may affect the probability to attend to plan choice and the actual decision process conditional on attention. Identification of our model comes from two sources: First, identification at infinity, as commonly assumed in the literature of selection models, can help to separate the two stages. Second, plan choices of those who cannot default to their old plan are used to pin down stable preferences for plan characteristics, which permits identification of switching costs conditional on attention.

We estimate the model using administrative data on Medicare Part D claims from 2007 to 2010. We find that consumers are more likely to pay attention to plan choice if their old plan gets worse, for instance due to premium increases, or if they experienced high out-of-pocket expenditures in the last year. Moreover, conditional on attention there are significant switching costs, corresponding to USD 300/year. Compared to the earlier literature on switching costs in health insurance markets, separating the mechanisms that lead to inertia results in much smaller – and arguably more plausible – estimates of switching costs.

Separating reasons for inertia is furthermore important for designing interventions to improve consumers' plan choice. Based on our model, we simulate how different interventions, such as increasing attention to plan choice (e.g. through a large information campaign) or reducing switching costs (e.g. by simplifying paperwork), affect plan choice. Preliminary results suggest that predicted overspending – the amount that individuals pay compared to what they would have paid in the cheapest plan available in their choice set – decreases when individuals are forced to pay attention and when switching costs are removed. Eliminating switching costs, however, has a much smaller effect on overspending than forcing individuals to attend to plan choice. We compare the simulation results we obtain from our two-stage models with the predictions from simpler models and find some important differences. Our tentative interpretation is that switching costs (in a narrow sense) have been over-emphasized; allowing for a separate inattention stage appears to be crucial.