

In Letter to Congress, Economists and Auction Experts Predict Medicare Bidding System for Medical Equipment Will Fail



We are economists, computer scientists, and operation researchers with expertise in the theory and practice of auctions.¹ We write to express our concerns with the Medicare Competitive Bidding Program for Durable Medical Equipment operated by the U.S. Department of Health and Human Services. We believe that competitive bidding can be an effective method of controlling Medicare costs without sacrificing quality. However, the current auction program has flaws that need to be fixed before it can achieve the objectives of low cost and high quality.

Four main problems

The first problem is that the auction rules violate a basic principle of auction design: *bids must be binding commitments*. In the Medicare auction, bidders are not bound by their bids. Any auction winner can decline to sign a supply contract following the auction. This undermines the credibility of bids, and encourages low-ball bids in which the supplier acquires at no cost the option to sign a supply contract.

The second problem is a flawed pricing rule. As is standard in multi-unit procurement auctions, bids are sorted from lowest to highest, and winners are selected, lowest bid first, until the cumulative supply quantity equals the estimated demand. What is odd is that rather than paying winners the clearing price (the last-accepted bid), the auction pays winners the unweighted median among the winning bids. This is unique in our collective experience. The result is that fifty percent of the winning bidders are offered a contract price *less than* their bids. This median pricing rule further encourages low-ball bids, since a low bid guarantees winning, has a negligible effect on the price and gives the supplier a free option to sign a supply contract. Even if suppliers bid their true costs, up to one-half of the winning suppliers would reject the supply contract and the government would be left with insufficient supply. Others may accept the contract and cross-subsidize public patients with the revenue from private patients, or just take a loss. This pricing rule does not develop a sustainable competitive bidding process or healthy supplier pool.

The third problem arises from the use of composite bids, an average of a bidder's bids across many products weighted by government estimated demand. This provides strong incentives to distort bids away from costs – the problem of bid skewing. Bidders bid low on products where the government overestimated demand and high on products where the government underestimated demand. As a result, prices for individual products are not closely related to costs. Bid skewing is especially problematic in this setting, since the divergence between costs and prices likely will result in selective fulfillment of customer orders. Orders for low-priced products are apt to go unfilled.

The fourth problem is a lack of transparency. It is unclear how quantities associated with each bidder are determined. These quantities are set in a non-transparent way in advance of the auction. Both quality standards and performance obligations are unclear. This lack of transparency is unacceptable in a government auction and is in sharp contrast to well-run government auctions such as the Federal Communications Commission spectrum auctions.

This collection of problems suggests that the program over time may degenerate into a “race to the bottom” in which suppliers become increasingly unreliable, product and service quality deteriorates, and supply shortages become common. Contract enforcement would become increasingly difficult and fraud and abuse would grow.

Key features of a good auction design

Competitive bidding techniques have improved dramatically over the past twenty years and especially in recent years. Complex auctions like the Medicare competitive bidding program can be designed to achieve the objectives of low cost and high quality with little implementation risk.

Successful government auctions emphasize transparency, good price and assignment discovery, and strategic simplicity. The result is sustainable long-term competition among suppliers which reduces costs while maintaining quality.

We recommend that the government fix the flaws in the current auction program and develop a new design that emphasizes the key features of successful designs. Implementation of the current design will result in a failed government program.

There is no need for a bad outcome. With state-of-the-art auction methods and careful implementation, the auction program can succeed in reducing costs while maintaining quality – a win-win for both taxpayers and Medicare beneficiaries.

Respectfully submitted,

Dilip Abreu, Princeton University
Itai Ashlagi, MIT
Susan Athey, Harvard University
Lawrence M. Ausubel, University of Maryland
Chris Avery, Harvard University
Ian Ayres, Yale University
Kerry Back, Rice University
Patrick L. Bajari, University of Minnesota
Sandeep Baliga, Northwestern University
Michael Ball, University of Maryland
David Baron, Stanford University
Michael Baye, Indiana University
Coleman Bazelon, Brattle Group
Dirk Bergemann, Yale University
Gary A. Biglaiser, University of North Carolina
Sushil Bikhchandani, UCLA
Kenneth Bimora, University College London
Andreas Blume, University of Pittsburgh
Simon Board, UCLA
Gary Bolton, Pennsylvania State University
Tilman Borgers, University of Michigan
Eric Budish, University of Chicago
James Bushnell, Iowa State University
Estelle Cantillon, Université Libre de Bruxelles
Andrew Caplin, New York University
Marco Celentani, Universidad Carlos III
Kalyan Chatterjee, Pennsylvania State University
Yoon-Koo Che, Columbia University
In-Koo Cho, University of Illinois
Peter Coles, Harvard University
Peter Cramton, University of Maryland
Vincent Crawford, University of Oxford
Jacques Cremer, Toulouse School of Economics

Robert Day, University of Connecticut
Luciano I. de Castro, Northwestern University
Francesco Decarolis, University of Wisconsin
George Deltas, University of Illinois
Peter DeMarzo, Stanford University
Raymond J. Deneckere, University of Wisconsin-Madison
Nicola Dimitri, University of Siena
David Dranove, Northwestern University
Marc Dudey, Rice University
Gregory M. Duncan, Brattle Group
Jeffrey Ely, Northwestern University
Itay Fainmesser, Brown University
Emel Filiz-Ozbay, University of Maryland
Dan Friedman, University of California Santa Cruz
Douglas Gale, New York University
Lawrence R. Glosten, Columbia University
Theodore Groves, University of California San Diego
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Jason Hartline, Northwestern University
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Donald Hausch, University of Wisconsin
Robert Hauswald, American University
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Ali Hortacsu, University of Chicago
Daniel Houser, George Mason University
Nicole Immorlica, Northwestern University

R. Mark Isaac, Florida State University
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David K. Levine, Washington University in St. Louis
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Tracy R. Lewis, Duke University
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Barton L. Lipman, Boston University
Ronald M. Harstad, University of Chicago
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Roger Myerson, University of Chicago
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Erkut Ozbay, University of Maryland
Marco Pagnozzi, University of Naples
Mallesh Pai, University of Pennsylvania
Ariel Pakes, Harvard University
Thomas Palfrey, California Institute of Technology
David Parkes, Harvard University
David Pearce, New York University
Motty Perry, University of Warwick
Nicola Persico, New York University
Martin Pesendorfer, London School of Economics
Michael Peters, University of British Columbia
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Robert Porter, Northwestern University
Andrew Postlewaite, University of Pennsylvania
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S. Raghavan, University of Maryland
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Al Roth, Harvard University
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Maher Said, Washington University in St. Louis
Larry Samuelson, Yale University

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Michael Waldman, Cornell University
Mark Walker, University of Arizona
Ruq Wang, Queen's University
Steven R. Williams, University of Illinois
Bart Wilson, Chapman University
Robert Wilson, Stanford University
Catherine Wolfram, University of California Berkeley
Dennis Yao, Harvard University
Pai-Ling Yin, MIT
Jaime Zender, University of Colorado

The views expressed here are our own and do not represent the views of any organization.

¹The co-signers above are economists, computer scientists, and operation researchers with expertise in the design of auctions and market mechanisms.

Information on each of us, including our auction-related research, can be found with an Internet search of name and affiliation. For additional information please contact Peter Cramton, University of Maryland, pccramton@gmail.com.

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