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Managing Imperfect Competition by Pay for Performance and Reference Pricing

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Abstract

I study a managed health service market where differentiated providers compete for consumers by choosing multiple service qualities, and where copayments that consumers pay and payments that providers receive for services are set by a payer. The optimal regulation scheme is two-sided. On the demand side, it justifies and clarifies value-based reference pricing. On the supply side, it prescribes pay for performance when consumers misperceive service benefits or providers have intrinsic quality incentives. The optimal bonuses are expressed in terms of demand elasticities, service technology, and provider characteristics. However, pay for performance may not outperform prospective payment when consumers are rational and providers are profit maximizing, or when one of the service qualities is not contractible.

Keywords: managed competition, multitasking, prospective payment, pay for performance, reference pricing, implementation

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