Medicare May Continue to Underpay Hospitals for the Most Costly Cases in FY 2008

The Medicare Inpatient Prospective Payment System (IPPS) pays hospitals on the basis of pre-determined rates. The system includes numerous technical adjustments based on factors such as local area wage differences, a hospital's indigent caseload, and whether a hospital has a teaching program. The system also allows additional payment for cases that are unusually costly, referred to as "outlier" cases.

The complexity of the IPPS makes it difficult to gauge the effects of changes to a particular component of the payment system. Some components are patient-specific, some are hospital-specific, and some are interrelated with other components. The Medicare program makes changes and updates to the IPPS each year but it can be extremely difficult for the industry to analyze all components.

One way to measure detailed impact is to use a base year of Medicare claims data and then compute IPPS payment on a patient-by-patient basis according to regulations for comparative fiscal years. Such an analysis was performed using FY 2006 Medicare inpatient claims with IPPS payment computed for fiscal years 2006-2008 according to respective regulations.

This analysis used the FY 2006 MedPAR file that was used in promulgating the final regulations for FY 2008. More than 3,400 short term acute care hospitals were included representing more than $100 billion in IPPS payments per year.

The Medicare Act Section 1886(d)(5)(A) calls for 5-6% of total IPPS payments to be paid for outliers. Despite this statutory provision, however, the analysis showed total outlier payments below the provision and declining each year. Though the statute was written before capital payment was phased into the prospective payment system, this study assumes that capital payment should be included in determining "total" payment.

Projected IPPS Payment for Outliers as a Percentage of Total ($billions)

	Total IPPS	Outliers	Outlier %
FY 2006	$103.2	$4.7	4.6%
FY 2007	$107.2	$3.8	3.5%
FY 2008	$108.9	$3.4	3.2%

The FY 2008 outlier percentage was subsequently adjusted to account for inflation in charges and corresponding changes in cost to charge ratios. After applying inflation factors used by CMS in the final regulations for FY 2008, the projected outlier percentage increases to 4.6% but still remains less than the statutory provision.

This shortfall occurs despite a reduction in the outlier threshold from $23,015 to $22,650 between the proposed and final regulations for FY 2008. Though CMS was evidently aware of a potential for underpayment, these projections indicate that proposed regulations may continue to underpay hospitals for treating unusually costly cases. Each 1% of underpayment represents a national shortfall of more than $1 billion.

TECHNICAL NOTES:

Data are based on the FY 2006 MedPAR, March file. This is a file of 100% of all Medicare fee-for-service claims representing discharges during the 12 months ending September 30, 2006 and billed as of 2/28/2007. This is the same file used by CMS in promulgating the final IPPS regulations for FY 2008. Only short-term acute care hospitals were included and hospitals were excluded if they did not have sufficient data to project IPPS for the periods studied.

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