

HOSPITAL ACUTE INPATIENT SERVICES PAYMENT SYSTEM

payment**basics**

Revised:
October 2024

Medicare beneficiaries receive inpatient care in about 3,150 short-term acute care hospitals paid under the inpatient prospective payment systems (IPPS).¹ Medicare's acute inpatient hospital benefit covers beneficiaries for 90 days of care per episode of illness, with a 60-day lifetime reserve. Illness episodes begin when beneficiaries are admitted and end after they have been out of the hospital or a skilled nursing facility for 60 consecutive days. Beneficiaries are liable for a deductible for the first hospital stay in an episode, for daily copayments on the 61st to 90th day of the episode, a higher daily copayment for lifetime reserve days used beyond the 90th day of the episode, and all costs once lifetime reserve days have been exhausted.²

In fiscal year 2022, the Medicare program and its beneficiaries spent \$111 billion on inpatient services covered under the IPPS. In addition, the Medicare program paid \$7.1 billion in uncompensated care payments to IPPS hospitals.³

Defining the inpatient acute care that Medicare buys

The IPPS primarily pays prospectively determined rates per inpatient stay for hospitals' operating and capital costs. (Certain costs are excluded from IPPS payments and paid separately, such as organ acquisition costs.) Related outpatient department services delivered in the three days before admission are included in the payment for the inpatient stay and may not be separately billed.

Setting the payment rates

Medicare's IPPS payments per stay are derived through a series of adjustments applied to separate operating and capital base payment rates (Figure 1). The two base rates are adjusted to reflect

geographic factors, patient case mix, facility characteristics, and other factors.

The base payment amounts Medicare sets operating and capital IPPS base rates (known as standardized payment amounts). Operating base payments are tied to labor and supply costs; capital base payments are tied to costs for depreciation, interest, rent, and property-related insurance and taxes. For fiscal year 2025, the operating base rate is \$6,624 and the capital rate is \$512.

Adjustment for geographic factors The operating and capital IPPS base rates are adjusted by a wage index to reflect the expected differences in local market prices for labor and labor-related costs. To determine the IPPS wage index for each hospital, CMS first calculates an unadjusted hospital wage index for each metropolitan statistical area and statewide rural area, which reflects the average hourly wage for employees of IPPS hospitals in that area relative to the nationwide average. CMS then applies several exceptions, including reclassifying some hospitals from one area to another and applying wage-index floors.

For operating base rates, the wage index is applied to the portion of the base rate attributable to wages and wage-related costs. This operating labor share is set by statute at 62 percent for hospitals with a wage index less than or equal to 1, and estimated by CMS for those with a wage index above 1. For capital base rates, the wage index raised to a fractional power is applied to 100 percent of the capital base rate.

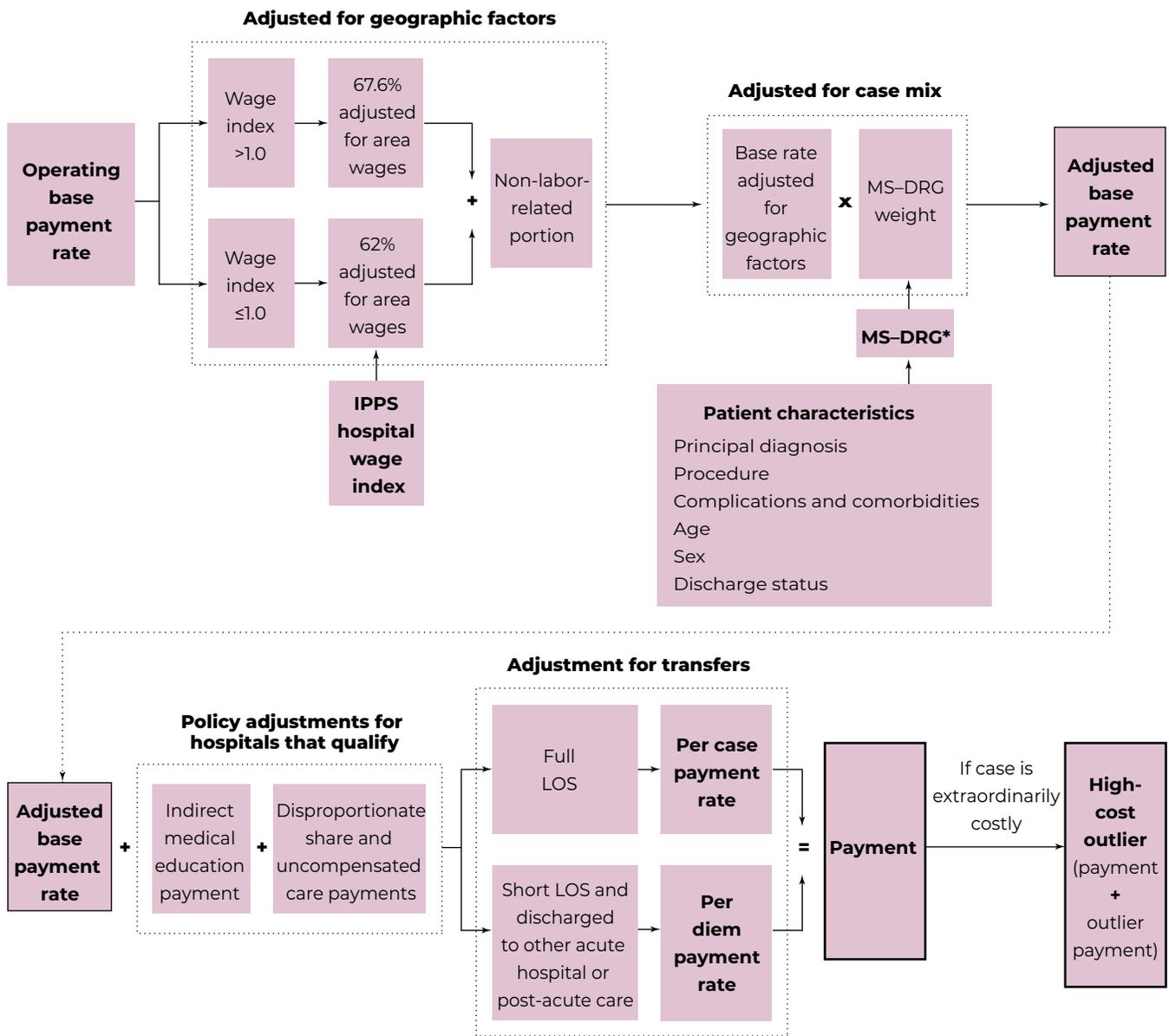
For hospitals in Alaska and Hawaii, both the operating and capital rates are boosted by a cost-of-living adjustment, reflecting the higher costs of supplies and other nonlabor resources in those states.

The policies discussed in this document were current as of September 30, 2024. This document does not reflect proposed legislation or regulatory actions.

MEDPAC

425 I Street, NW
Suite 701
Washington, DC 20001
ph: 202-220-3700
www.medpac.gov

Figure 1 Acute inpatient operating prospective payment system for fiscal year 2025



Note: MS-DRG (Medicare severity diagnosis related group), LOS (length of stay). Capital payments are determined by a similar system. Additional payments are also made for certain new technologies and rural or isolated hospitals. Hospitals may receive penalties or additional payments based on their performance on quality standards.
 *MS-DRGs comprise base DRGs subdivided into one, two, or three severity levels.

Adjustment for case mix For each inpatient stay, the hospital's geographic-adjusted operating and capital rates are then adjusted for case mix to reflect the patient's condition and expected costliness. To determine this stay-level case-mix adjustment, Medicare assigns each inpatient

stay to a Medicare severity diagnosis related group (MS-DRG), which is based on patient characteristics, primarily the patient's clinical conditions and treatment strategies. Clinical conditions are defined by the principal diagnosis—the main problem requiring inpatient care—and up

to 24 secondary diagnoses indicating other conditions that were present at admission (comorbidities) or developed during the hospital stay (complications). The treatment strategy—surgical or medical—is defined by the presence or absence of up to 25 procedures performed during the stay. In 2025, the MS-DRG system includes 345 base DRGs, most of which are split into 2 or 3 MS-DRGs based on the presence of either a comorbidity or complication (CC) or major CC, resulting in a total of 773 MS-DRGs.

Each MS-DRG has a weight that reflects the expected costliness of inpatient treatment for patients in that group relative to the expected costliness across all patient groups.

Indirect medical education payments

Hospitals that train residents receive additional operating and capital IPPS payments to offset the additional (indirect) costs of patient care associated with resident training that are not otherwise accounted for under the IPPS. These indirect medical education (IME) payments are calculated as a percentage add-on to geographic- and case-mix-adjusted base rates. The size of the IME percentage add-on depends on the hospital's teaching intensity, defined as the hospital's allowed number of residents per inpatient bed (for operating IME) or allowed residents per average daily inpatient census (for capital IME).

Disproportionate share and uncompensated care payments Hospitals that treat a disproportionate share (DSH) of certain low-income patients receive additional operating and capital payments intended to offset the financial effects of treating these patients. DSH payments are calculated as a percentage add-on to geographic- and case-mix-adjusted base rates. The size of the DSH percentage add-on depends on the hospital's low-income patient share, defined as the sum of the proportion of its Medicare inpatient days provided to patients eligible for Supplemental Security Income benefits and the proportion of its total acute inpatient days furnished to Medicaid patients. Any hospital with a low-income share exceeding

15 percent is eligible to receive operating DSH payments. (To be eligible for capital DSH payments, hospitals must also be urban and have 100 or more beds.)

In addition, each DSH hospital receives uncompensated care payments from a fixed pool of dollars referred to as the "uncompensated care pool." In fiscal year 2025, the uncompensated care pool is \$5.7 billion dollars and is allocated to DSH hospitals based on their share of reported uncompensated care costs in 2019, 2020, and 2021 relative to all other hospitals receiving DSH payments.⁴ (Capital DSH payments are based on a prior-law DSH formula and do not include a component based on uncompensated care.)

Transfer policy Facing fixed inpatient payment rates, providers have financial incentives to reduce their inpatient costs by moving some services to another setting. To counter these incentives, IPPS payments for a stay are reduced when patients have a length of stay at least one day less than the geometric mean length of stay for the MS-DRG and:

- are either transferred to another hospital covered by the IPPS or designated as a critical access hospital or
- for certain DRGs, discharged to a post-acute care setting.⁵

Under this policy, transferring hospitals are paid a per diem rate rather than the full MS-DRG payment. Generally, hospitals receive twice the per diem rate for the first day and the per diem rate for each additional day.⁶

New-technology payments Hospitals with cases treated using certain new and expensive technologies receive add-on payments to offset the costs of these new technologies. CMS evaluates applications for new-technology add-on payments (NTAP) submitted by technology firms and others based on criteria of newness, substantial clinical improvement, and the cost of the technology exceeding MS-DRG-specific thresholds.⁷ For cases

involving eligible new technologies, NTAPs are generally set at 65 percent (or 75 percent for certain technologies) of the lesser of (1) the costs of the new technologies or (2) the amount by which the costs of the case exceed the otherwise applicable IPPS operating payment (including IME and DSH).⁸

Outlier payments Medicare makes extra payments for cases that are extraordinarily costly.

High-cost outlier cases are identified by comparing the cost of that case to a threshold that is the sum of the hospital's:

- geographic- and case-mix-adjusted base payment for the case (both operating and capital);
- any IME, DSH, uncompensated care, and new-technology payment; and
- a fixed loss amount (subject to geographic and transfer adjustments, as applicable).

For each case that exceeds the threshold, Medicare makes an outlier payment equal to 80 percent of the hospital's costs above the threshold (or 90 percent for burn cases).

Outlier payments are financed by prospective offsetting reductions in the operating base rate and the capital base rate. CMS sets the national fixed loss amount at the level it estimates will result in outlier payments equaling the target operating offset of 5.1 percent (plus a projection for outlier reconciliation, which was 0.04 percentage points in 2025). In 2024, the national fixed loss amount is \$46,217 and the offset to the capital base rate was 4.23 percent.

Special payments for rural or isolated hospitals Medicare makes additional payments to certain rural or isolated hospitals.

Sole community hospital payments—The sole-community hospital (SCH) designation is for hospitals that are located at least 35 miles from the nearest short-term acute care hospital or are located in a rural area

and meet criteria related to isolation.

These hospitals receive inpatient operating payments equal to the higher of payments under the IPPS or payments based on their costs per stay in a base year updated to the current year and adjusted for their current year case mix.

Medicare-dependent hospital payments—

The Medicare-dependent hospital (MDH) program is for small, rural hospitals not designated as a SCH in which Medicare patients comprise at least 60 percent of their admissions or patient days. These hospitals receive inpatient operating payments equal to the higher of standard IPPS rates or a blend of standard IPPS rates (25 percent) and their historical costs updated to the current year and adjusted for changes in their case mix (75 percent). The MDH program is scheduled to expire on December 31, 2024.

Low-volume hospital payments—The low-volume hospital designation is for hospitals that have a low number of discharges and meet criteria related to isolation. For fiscal year 2025, to be eligible a hospital must have fewer than 3,800 total discharges and be located more than 15 road miles from the nearest hospital (excluding critical access hospitals and Indian Health Service hospitals). These hospitals receive up to a 25 percent increase in their IPPS payments (including geographic- and case-mix-adjusted operating and capital base payments, and any IME, DSH, uncompensated care, new-technology, outlier, SCH, or MDH payments). These broader eligibility requirements are scheduled to expire on December 31, 2024.

Quality incentive payments and penalties

Excess readmissions penalty—Under the Hospital Readmissions Reduction Program, hospitals that have excess Medicare readmissions for selected conditions have their adjusted operating base payments reduced by up to 3 percent. In fiscal year 2025, the readmissions policy applies to six conditions (acute myocardial infarction, heart failure, pneumonia, chronic

obstructive pulmonary disease, total hip and knee arthroplasty, and coronary artery bypass graft).

Value-based incentive payments—Under the value-based purchasing program, CMS redistributes a pool of dollars equal to 2 percent of adjusted operating base payments based on performance on a set of outcome, patient experience, safety, and efficiency measures.

Hospital-acquired conditions penalty—Under the Hospital-Acquired Condition Reduction Program, hospitals are ranked on their total rate of preventable conditions such as falls, surgical site infections, and catheter-associated urinary tract infections. The 25 percent of hospitals with the highest rates of preventable conditions generally receive a 1 percent reduction in all inpatient payments.

Payment-rate updates

CMS makes several annual updates to IPPS payment rates, including updates to the base rates, wage indexes, MS-DRG definitions and weights, and the outlier fixed loss amount.

IPPS base rates are updated annually primarily based on the applicable market basket index and estimates of changes in productivity. For 2025, the operating base rate reflects an annual update of 2.9 percent. The update is the sum of the hospital market basket (which measures the price increase of goods and services hospitals buy for patient care) of 3.4 percent, less a productivity adjustment of 0.5 percentage points.⁹ The Secretary determines the annual update to the capital payment rate based on the capital market basket and other factors. In 2025, the update to the capital base rate reflects an annual update of 3.1 percent. ■

¹ The IPPS includes two prospective payment systems: one for inpatient operating costs and one for inpatient capital costs. Approximately 1,350 rural hospitals qualify as critical access hospitals and are paid on a reasonable cost

basis instead of under the IPPS. The Critical Access Hospitals Payment System document in our *Payment Basics* series provides more information on this topic. Short-term acute care hospitals in Maryland and territories other than Puerto Rico, children's hospitals, psychiatric hospitals, and cancer hospitals are also exempt from the IPPS and paid under other rate systems.

- 2 Medicare pays the approved amount minus any beneficiary liability, such as a deductible or copayment; the provider then needs to collect the remaining amount from the beneficiary or a supplemental insurer. In 2024, the inpatient deductible is \$1,632 per episode and the daily copayments are \$408 from the 61st to 90th day of an episode and \$816 per lifetime reserve day. Medicare reimburses providers for 65 percent of bad debts resulting from beneficiaries' nonpayment of deductibles and copayments after providers have made reasonable efforts to collect the unpaid amounts.
- 3 This spending reflects the postsequester rates set by the IPPS, including any applicable beneficiary cost-sharing responsibilities. It does not account for any potential unreimbursed bad debt.
- 4 Starting in fiscal year 2023, CMS discontinued the use of a low-income day proxy to measure uncompensated care costs for hospitals in Puerto Rico and Indian Health Services and tribal hospitals. To protect these hospitals from significant financial disruption, CMS also established new supplemental uncompensated care payments for these hospitals, which CMS estimates will total \$80 million in fiscal year 2025.
- 5 The post-acute care settings covered by the transfer policy include long-term care hospitals; inpatient rehabilitation, inpatient psychiatric, or skilled nursing facilities; hospice care; and home health care if the patients receive clinically related care that begins within three days after the hospital stay.
- 6 An exception exists for certain MS-DRGs with high first-day costs. These transfer cases are paid half the full MS-DRG payment plus one per diem payment and half the per diem rate for subsequent days.
- 7 CMS has specified alternative eligibility pathways for new technologies designated by the Food and Drug Administration (FDA) as Breakthrough Devices or qualified infectious disease products (QIDP) or approved by the FDA under the limited population pathway for antibacterial and antifungal drugs (LPAD); these need to meet only the NTAP cost criterion.
- 8 Products granted an NTAP that are designated by the FDA as QIDP or LPAD receive a 75 percent NTAP payment, instead of 65 percent.
- 9 Hospitals that fail to provide data on specified quality indicators or to be meaningful users of electronic health records receive only a fraction of the IPPS operating market basket update.