

TABLE III.—COMPARISON OF TOTAL PAYMENTS PER CASE—Continued
[FY 2003 payments compared to proposed FY 2004 payments]

	Number of hospitals	Average FY 2003 payments/case	Average FY 2004 payments/case	Change
Other Reclassified Hospitals (Section 1886(D)(8)(B))	34	486	472	–2.8
Type of Ownership:				
Voluntary	2,404	719	726	1.0
Proprietary	674	691	697	0.9
Government	813	645	652	1.2
Medicare Utilization as a Percent of Inpatient Days:				
0–25	291	901	914	1.4
25–50	1,529	804	812	0.9
50–65	1,645	615	621	1.0
Over 65	446	556	561	1.0

Appendix B: Recommendation of Update Factors for Operating Cost Rates of Payment for Inpatient Hospital Services

I. Background

Section 1886(e)(4)(A) of the Act requires that the Secretary, taking into consideration the recommendations of the Medicare Payment Advisory Commission (MedPAC), recommend update factors for inpatient hospital services for each fiscal year that take into account the amounts necessary for the efficient and effective delivery of medically appropriate and necessary care of high quality. Under section 1886(e)(5) of the Act, we are required to publish the proposed update factors recommended under section 1886(e)(4) of the Act in this proposed rule, and the final update factors recommended by the Secretary in the final rule. Accordingly, this Appendix provides the recommendations of appropriate update factors for the IPPS standardized amounts, the hospital-specific rates for SCHs and MDHs, and the rate-of-increase limits for hospitals and hospital units excluded from the IPPS. We also discuss our update framework and respond to MedPAC's recommendations concerning the update factors.

II. Secretary's Recommendations

Section 1886(b)(3)(B)(i)(XIX) of the Act sets the FY 2004 percentage increase in the operating cost standardized amounts equal to the rate of increase in the hospital market basket for IPPS hospitals in all areas. Based on the Office of the Actuary's first quarter 2003 forecast of the FY 2004 market basket increase, the proposed update to the standardized amounts is 3.5 percent (that is, the market basket rate of increase) for hospitals in both large urban and other areas.

Section 1886(b)(3)(B)(iv) of the Act sets the FY 2004 percentage increase in the hospital-specific rates applicable to SCHs and MDHs equal to the rate set forth in section 1886(b)(3)(B)(i) of the Act (that is, the same update factor as all other hospitals subject to the IPPS, or the rate of increase in the market basket). Therefore, the proposed update to the hospital-specific rate applicable to SCHs and MDHs is also 3.5 percent.

Under section 1886(b)(3)(B)(ii) of the Act, the FY 2004 percentage increase in the rate-

of-increase limits for hospitals and hospital units excluded from the IPPS (psychiatric hospitals and units, rehabilitation hospitals and units (now referred to as IRFs), LTCHs, cancer hospitals, and children's hospitals) is the market basket percentage increase. In the past, hospitals and hospital units excluded from the IPPS have been paid based on their reasonable costs subject to limits as established by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). However, some of these categories of excluded hospitals and units have begun to be paid under prospective payment systems. Hospitals and units that receive any hospital-specific payments will have those payments subject to TEFRA limits for FY 2004. For these hospitals, the proposed update is the percentage increase in the excluded hospital market basket (currently estimated at 3.5 percent).

IRFs are paid under the IRF PPS for cost reporting periods beginning on or after January 1, 2002. For cost reporting periods beginning during FY 2004, the Federal prospective payment for IRFs is based on 100 percent of the adjusted Federal IRF prospective payment amount, updated annually.

Effective for cost reporting periods beginning during FY 2003, LTCHs are paid under the LTCH PPS under which they receive payment based on a 5-year transition period (see the August 30, 2002 final rule (67 FR 55954)). An LTCH may elect to be paid on 100 percent of the Federal prospective rate at the start of any of its cost reporting periods during the 5-year transition period. For purposes of the update factor, the portion of the LTCH PPS transition blend payment based on reasonable costs for inpatient operating services is determined by updating the LTCH's TEFRA limit by the current estimate of the excluded hospital market basket (or 3.5 percent).

III. Update Framework

Consistent with current law, we are proposing an update recommendation equal to the full market basket percentage increase for the IPPS operating cost standardized amounts for FY 2004. We also have analyzed changes in hospital productivity, scientific and technological advances, practice pattern changes, changes in case-mix, the effect of reclassification on recalibration, and forecast

error correction. A discussion of this analysis is below.

A. Productivity

Service level labor productivity is defined as the ratio of total service output to full-time equivalent employees (FTEs). While we recognize that productivity is a function of many variables (for example, labor, nonlabor material, and capital inputs), we use the portion of productivity attributed to direct labor since this update framework applies to operating payment. To recognize that we are apportioning the short-run output changes to the labor input and not considering the nonlabor inputs, we weight our productivity measure by the share of direct labor services in the market basket to determine the expected effect on cost per case.

Our recommendation for the service productivity component is based on historical trends in productivity and total output for both the hospital industry and the general economy, and projected levels of future hospital service output. MedPAC's predecessor, the Prospective Payment Assessment Commission (ProPAC), estimated cumulative service productivity growth to be 4.9 percent from 1985 through 1989 or 1.2 percent annually. At the same time, ProPAC estimated total output growth at 3.4 percent annually, implying a ratio of service productivity growth to output growth of 0.35.

Absent a productivity measure specific to Medicare patients, we examined productivity (output per hour) and output (gross domestic product) for the economy. Depending on the exact time period, annual changes in productivity range from 0.30 to 0.35 percent of the change in output (that is, a 1.0 percent increase in output would be correlated with a 0.30 percent to a 0.35 percent change in output per hour).

Under our framework, the recommended update is based in part on expected productivity—that is, projected service output during the year, multiplied by the historical ratio of service productivity to total service output, multiplied by the share of direct labor in total operating inputs, as calculated in the hospital market basket. This method estimates an expected productivity improvement in the same proportion to expected total service growth that has occurred in the past and assumes that, at a minimum, growth in FTEs changes