1 big thing: Into the hospital margin rabbit hole

Illustration: Annelise Capossela/Axios

I wanted to write about hospital Medicare margins this week, but as I started talking to people, they didn't really want to talk about the numbers; they wanted to talk about how analyzing them is kind of pointless because hospital costs are at least partially a product of choice.

Why it matters I: The idea that hospitals can control their costs more than they let on challenges their primary defense of business practices that some economists already decry as indefensible or, at least, unsustainable.

Driving the news: The takeaway from a recent Third Way report is that more than half of hospitals make money on Medicare.

- And some hospitals make more money on Medicare patients than others; including for-profits, critical access hospitals, and independent hospitals, according to further Third Way analysis provided to Axios.

Why it matters II: If the U.S. is ever going to seriously address its high health care costs, the solution will almost certainly have to include hospital spending, which makes up the largest chunk of total spending.

- But hospitals argue that the industry is barely getting by, especially in the post-pandemic era of high labor costs and inflation. And no one disputes that many hospitals around the country are struggling to stay afloat.
- Efforts to cut from their more lucrative lines of business — thus saving patients and taxpayers money — would upset the delicately designed balance sheet, hospitals say, because they need those profits to offset the losses they incur from Medicare and Medicaid.
- But the Third Way analysis presents a different narrative: Hospitals can — and often do — make money off of Medicare. Economists argue those who don't may have little incentive to try, at least via lowering their costs.

The big picture: "Hospitals' costs are in their control, and so there are plenty of hospitals that see lots of Medicaid patients who are able to make money on Medicare patients," said Zack Cooper, a health economist and Yale professor.

- "Conversely, some of these academic medical centers are set up to primarily make money off of the privately insured and attract privately insured patients," he added. "So it often looks like they're making losses on Medicare patients, but that's a choice that they've made."

"Margins you have revenue and cost. If cost is inflated, then the margins may not be representing what's truly happening," said Arnold Ventures executive vice president Mark Miller.

- "The question is, how much of that is legitimate, and how much of that is being driven by the fact that they're being paid so much on the commercial side that their costs are being driven by that."

The other side: "The report doesn't acknowledge that according to the government's own data via the Medicare Payment Advisory Commission (MedPAC), the federal body charged with advising Congress on the Medicare program, hospitals' Medicare margins for inpatient care in 2022 were *negative* 11.6%," the AHA wrote in a blog postresponding to the report.

- "Said another way, hospitals *lost* $100 billion by providing care to Medicare patients."

Between the lines: The AHA is correct: The Third Way conclusion is pretty different than MedPAC's. The report's authors say that's because of methodology and how the groups account for costs and revenue.

- But the variability in hospitals' financial performance is consistent, as is the on-its-face somewhat counterintuitive relationship between Medicare margins and commercial prices.
- That argument goes like this: Hospitals that can obtain more revenue from private insurers have more money and less incentive to keep their costs down. In fact, nonprofit hospitals often plow excess revenue right back onto the balance sheet as costs.
- That makes the cost component of the Medicare margin equation higher at these hospitals with more commercial patients and/or higher commercial prices.

In MedPACspeak from earlier this year: "Ascertaining the 'true' costs of care for Medicare beneficiaries is challenging ... when providers receive high payment rates from insurers, they face less pressure to keep their costs low, and so, all other things being equal, their FFS Medicare margins are low because their costs are high."

- And to really drive this full circle, MedPAC links this dynamic back to consolidation, which we've talked about a lot in this newsletter.
- "Lack of fiscal pressure is more common in markets where a few providers dominate and have negotiating leverage over payers. This situation is becoming more common as providers continue to consolidate."

Let's get into the nitty gritty below...

2. Diving into the weeds

Data: Third Way calculations based on NASHP data. Chart: Jared Whalen/Axios

Time to get wonky about margins! Let's start with the topline:

- The Third Way analysis found that 55% of hospitals made money on Medicare in 2022, based on hospitals' own financial reports.
- Third Way combined traditional Medicare and Medicare Advantage for this analysis. The data they used show that Medicare margins are, on average, -5% for traditional Medicare and 0% for Medicare Advantage, author David Kendall told me.
- MedPAC, on the other hand, reported earlier this year that hospitals' average Medicare margin fell to a "record low" in 2022, which was -11.6% (This is the number quoted by the AHA if you recall from above).

Details: Third Way used a dataset compiled bythe National Association for State Health Policy and supported by Arnold Ventures that uses cost reports submitted by hospitals to the federal government.

- The AHA in its blog post argued that the dataset "inflates hospitals' margins by both undercounting hospital costs as well as incorrectly counting hospital revenue (including by assuming revenue that demonstrably does not exist)."

I called up Arnold's Miller to discuss the differences between the datasets since he's a former MedPAC executive director in addition to his current title.

- He said the datasets have different purposes, so neither is the "right" one. But he wanted to talk more about the fake costs idea, and he said Third Way's finding that independent hospitals have better Medicare margins than health systems makes perfect sense.
- "If you have pressure from your revenue, you actually contain your costs. But if you're a large hospital system, you have a consolidated position in the market, you're not under fiscal pressure and your costs are higher," he told me.
- "The richest hospitals in this country have the worst Medicare margins. It's so much revenue that their costs follow the revenue, and that, of course, made them much worse on Medicare."

When you hear hospitals talk about "investments," those are costs. At a very high level, they can be broken down into clinical and non-clinical spending.

- "Imagine I make lots of profits in one year and I decide to build a new cancer center or I choose to recruit a bunch of really good doctors at really high pay. That's going to make my costs pretty high," Yale's Cooper said.
- "I'd rather them go to high-quality doctors than self-playing musical instruments in the lobby," he added.

The bottom line: Separate research has found that hospitals with more potentially privately insured patients have higher quality, which takes money.

- "As the spread between private and Medicare goes up, you're more incented to attract more privately insured patients, and part of the way you attract more privately insured patients is really investing in things that privately insured patients want," Cooper said.

My thought bubble: Thanks for coming with me on this journey, where we basically ended up at the idea that hospitals' costs may be related to the kind of patients they want to — or do — attract. And that's not people with lower-paying government insurance, at least when looking at it through a financial lens.

- That seems to me like a pretty big idea in itself — hit reply if you have thoughts!