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Judge rules Medicaid payment system illegal

by Linda Everett

On July 3, a federal judge threw out Washington State's Medicaid payment system, calling it "arbitrary and capricious" and a violation of federal law, because it inadequately paid hospitals for costs incurred for treating Medicaid patients. The decision comes at a point when federal mandates to states to provide broader Medicaid benefits, combined with growing numbers of unemployed and massive state budget deficits, have led legislators to order brutal rate cuts to hospitals.

Until recently, the state of Oregon, for example, paid hospitals only 59¢ for every dollar spent for providing services. Hospitals in 21 states responded by suing for higher rates. While each of the eight suits settled so far was resolved in favor of the hospital, U.S. District Judge Thomas Zilly's ruling has national implications and may force states to reexamine how they pay hospitals for treating the poor.

In his 129-page decision, Judge Zilly explains how the state of Washington does not abide by the 1981 Boren Amendment to the Medicaid Act. The Medicaid program is a cooperative federal-state program in which the federal government matches what states pay hospitals that provide care to Medicaid recipients. From 1972 to 1981, Congress required that state reimbursements to providers reflect the cost necessary to provide services of adequate quality. In 1981, Congress amended the Medicaid law and no longer required that hospital payments be linked to the *actual* costs of treating a Medicaid patient. Instead, the Boren Amendment said states must assure that their payment rates are "reasonable and adequate" to cover the costs incurred by "efficiently and economically operated" hospitals for treating Medicaid recipients. The "reasonable rates" assurance is the central issue in the Washington hospital suit challenging state payment plans.

Hospitals being cheated

Judge Zilly painstakingly analyzed each tortuous turn in Washington State's rate-cutting methodologies since 1985, in 173 separate Findings of Fact and 63 Conclusions of Law. Suffice it to say that the state, with the help of Peat Marwick Main and Co. consultants, spewed out so many convoluted schemes of ratio juggling in an effort to chisel ever larger chunks out of hospital payments, that they reduced themselves to the level of con-artists.

In 1985, Washington State's Department of Social and Health Services (DSHS) adopted a prospective payment system for reimbursing inpatient hospital services. The state used diagnosis related groupings (DRGs), in which they paid a facility a flat rate based on a patient's diagnosis, not on the cost of treatment or the length of stay. Within a year, DSHS cut these low hospital rates by 23.7% across the board. Although this cut was voided in court in May 1987, the governor called for another cut to Medicaid of $25.8 million in early 1987. To appease demands for more Medicaid cuts, DSHS adopted a ghastly second generation of DRGs which utilized methodologies appropriate to a bunch of flim-flam men.

Here's one example. To cut the base year costs used to set the hospitals' second generation DRG payment rate, DSHS removed the costs of hospitals' caring for "outliers." These are cases with extraordinarily high costs. This resulted in a substantial understatement of total hospital costs and a significantly reduced average cost, thereby severely lowering the rate of reimbursement to hospitals.

DSHS also implemented new payment schemes more than a year before the Health Care Financing Administration (HCFA) which oversees Medicaid, reviewed and rejected them—hospitals never recovered the millions they were short-changed each time. Judge Zilly repeatedly found that DSHS never investigated to "find" or ensure that its payment rates were adequate to meet costs as the law required or were within *any* "zone of reasonableness."

In fact, according to one estimate, 1988 DRG payments to hospitals were less than their 1985 actual Medicaid costs. Hospitals receive only about 79% of the actual costs they incur. The state only fully pays the costs involved about 12% of the time.

Washington State claims all of the hospitals in the state are not efficient, so the state reduced 1988 hospital payments to "encourage cost-containment." The judge dismissed the claim as "not credible," saying rate changes were driven by budgetary considerations. The state "proved" hospitals were not efficient because they had 33% "excess" beds, costing over $164 million in 1985. Their study showed that one hospital had 43 excess beds out of 176 beds, resulting in costs of $2.8 million for that hospital in 1988. In fact, that hospital converted those 43 beds to outpatient and other uses, and even more remarkable, its total operating expenses for 1988 were less than $2.8 million.

Low state-reimbursement rates force hospitals to shift the costs of caring for Medicaid patients to private paying patients, and forces providers to borrow, both contributing to increased health care costs. Moreover, state and federal leaders have reduced the fundamental role of health care, from one upholding the inviolability of human life, to a budget item. While the U.S. Supreme Court ruled last year that hospitals have the right to sue states for decent Medicaid reimbursement, Judge Zilly's ruling defines the procedural requirements to make sure states provide adequate care.

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