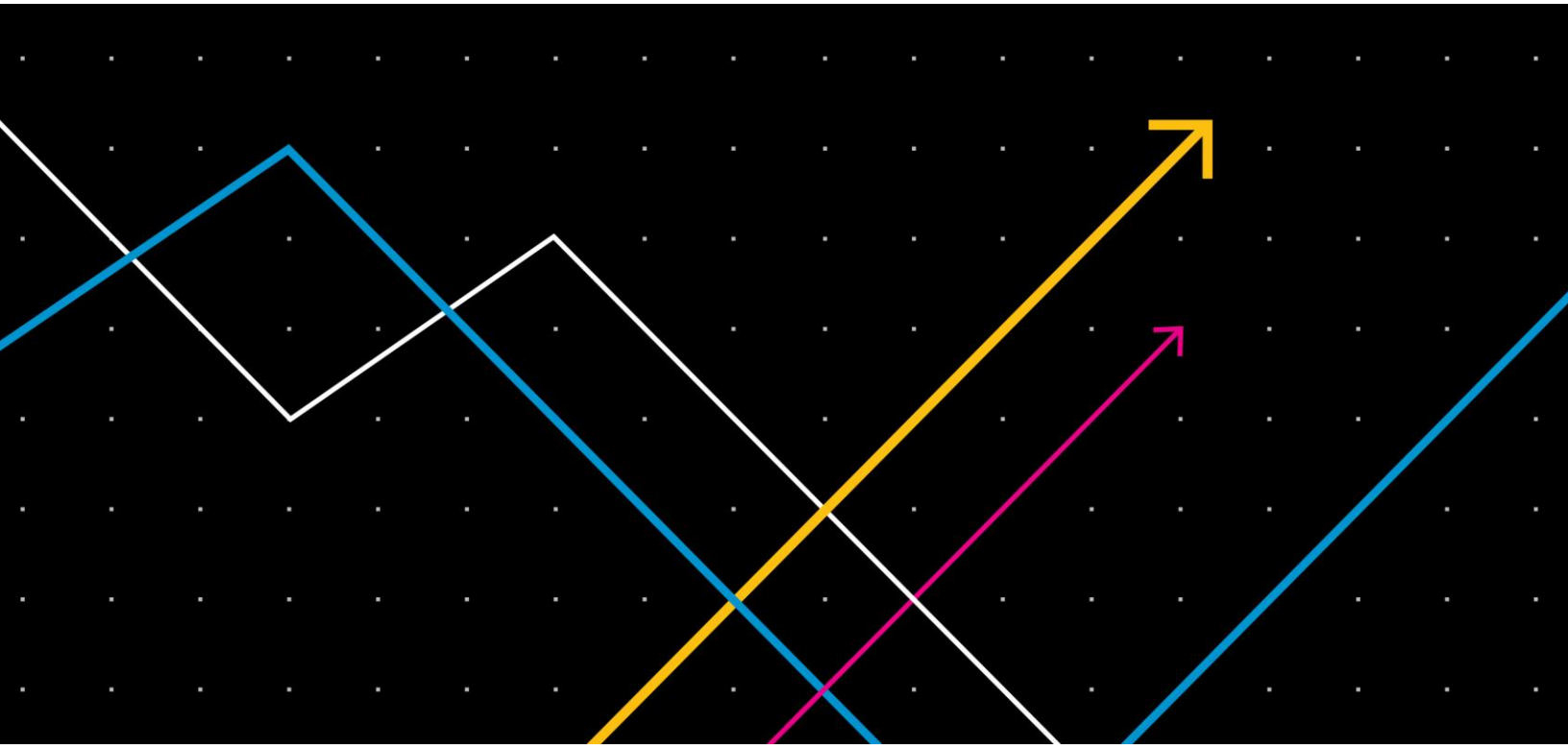

RESEARCH REPORT

Payment Methods and Benefit Designs: How They Work and How They Work Together to Improve Health Care

Introduction to *Payment Methods: How They Work*

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OUR HEALTH CARE SYSTEM NEEDS CPR

CATALYST FOR PAYMENT REFORM

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Contents

Payment reform promises to substitute value for volume. Yet, value- and volume-based approaches typically are implemented together. All payment methods have strengths and weaknesses, and how they affect the behavior of health care providers depends on their operational design features and, crucially, on how they interact with benefit design. Those seeking greater value for their health care dollar are also turning to innovation in benefit design, which also typically involves the implementation of more than one approach at a time—each with its own strengths, weaknesses, and effect on consumer health care behavior. Although payment and benefit design each has received significant attention independently, the intersection between the two has received little if any. The Urban Institute partnered with Catalyst for Payment Reform to explore how established and proposed payment methods and benefit design options work on their own and together. We also examined how payment and benefit design can be blended to improve health care delivery. This is the introduction to the report *Payment Methods: How They Work*. All reports and chapters can be found on our project page: Payment Methods and Benefit Designs: How They Work and How They Work Together to Improve Health Care.

Introduction

The broad policy consensus that payment methods for physicians and hospitals need to evolve from volume based to value based often implicitly assumes clear dividing lines between the two categories. However, most of what are considered value-based payment reform models are being implemented on top of current, volume-based payment approaches, or as HHS calls it, "fee-for-service architecture." This points to our need to understand the attributes of all common payment approaches—those long in use and more recent reforms—to better judge not only their strengths and weaknesses as stand-alone payment methods but also how they likely interact with other payment methods. With this knowledge, we can adopt designs that improve the effectiveness of payment reform models.

Accordingly, to gain a better understanding of payment reform opportunities, we explore not only the attributes of reform approaches but also payment methods that constitute their underlying architecture. Our review demonstrates that, in fact, every payment method has strengths and weaknesses. By understanding them, it might be possible to implement payment reform designs that take advantage of their strengths and mitigate their weaknesses. Often the best way is to develop mixed or hybrid payment models that accentuate the strengths of each method while mitigating the negative attributes.

Busse and Quentin (2011) make this conclusion on the broad adoption of diagnosis related groups (DRGs) in most European countries:

> The payment of hospitals in all countries … consists of a highly sophisticated mix of different payment mechanisms that aim to modify the type and strength of the incentives in DRG-based hospital payment. The resulting intricately blended payment systems—incorporating elements of fee-for-service payment, per diem payment and global budgets—are more likely to contribute to achieving the societal objectives of securing high-quality hospital care at affordable costs than any other hospital payment mechanism alone.(p. 164)

Our primary considerations in describing the attributes of payment systems are how payment methods can be designed to maximize their potential and mitigate their weaknesses and how adoption of complementary payment and benefit designs can enhance their strengths. In addition, payment attributes include other considerations that round out the core elements to be considered when deciding which payment methods to adopt and in what combinations.

Context, Design, and Operational Issues Affect Payment Method Impact

Too often, analyses of payment methods are based on idealized versions and focus on the incentives the payment method embodies while ignoring practical issues that influence how it will behave when adopted and implemented.

The context of a payment methods' adoption often matters crucially to its impact. For example, traditional Medicare sets payment rates, whereas private payers have to negotiate rates. Pricing power resulting from some forms of consolidation may therefore have differential impacts on the success of payment methods, such as population-based payments, designed for large provider organizations. Similarly, private payers have more flexibility than traditional Medicare to design benefits that complement particular payment approaches, such as tiered or narrow networks. To pay hospitals through global budgets requires an all-payer system that addresses payments across the board—no individual payer, even one as important as Medicare, can itself pay hospitals through global budgeting. The context matters.

The specific design of the payment method, including the relative generosity of the payments, can also strongly influence the effect on providers' behavior. A fee schedule inherently contains incentives to provide more services, often more than needed or appropriate. But misvaluation of fees (i.e., payments far more or less than cost of production) will favor certain services more than others. Under

population-based payment approaches, such as those for accountable-care organizations, payments are accompanied by measurements of quality for preventive services. Such a policy may reduce the temptation inherent in the payment method to stint on these services. Evaluating the impact of the payment method without factoring in the policy design can lead to inaccurate conclusions.

Finally, in describing the theoretical incentives any payment method produces, analysts may miss the substantial operational challenges of implementation. These include administrative feasibility and the potential for perverse, unintended provider responses that can defeat the method's purpose. Anticipating and addressing operational challenges in design through accompanying policies and oversight may resolve the concerns. Yet, sometimes, implementation challenges may make a conceptually logical payment method too difficult to actually put into place.

Payment Method Attributes

Despite "it all depends" caveats that offer cautions before definitive conclusions about the growing array of payment options in use or proposed, policymakers should consider payment methods' attributes to decide how (or whether) to proceed with payment reform. Identifying payment methods' attributes can also instruct consumers, patients, providers, payers, and policymakers about their potential benefits and harms, informing how monitoring and oversight might proceed. Further, too much of the discussion of payment reform has focused on payment models' theoretical effects rather than on their interactions with other payment methods. We must also consider interaction with an array of benefit designs that either encourage or frustrate the opportunities for payment reform to improve value.

Advised by a technical expert panel of payment and benefit design experts, we selected the nine provider payment methods used most commonly by third-party payers or insurers—public and otherwise—to pay physicians and hospitals. Understanding how each payment method works, with its strengths, weaknesses, and other attributes identified, will help us find complementary payment and benefit design approaches that combine the strengths and mitigate weaknesses inherent in each payment method.

Methods and Analysis

All payment methods reviewed here have been peer-reviewed in the literature. However, we do not consider the available research-based evidence definitive, largely because research on payment methods depends on the specific payment design, including the generosity of payment, the context in which it would be applied, and the ability to manage attendant operational challenges. To generalize from the available, somewhat limited literature would be misleading. At the same time, others have reviewed payment approaches, crafting their own assessments similar to ours. What makes our review unique is our concise summaries of the payment methods' most salient attributes. We list the primary sources we relied on for much of our information and judgment, but we do not attempt to reference literature for every observation made. Our review is not intended for an academic audience, but rather as a practical guide for stakeholders interested in learning more about payment and its intricacies.

In addition, we have largely relied on informed, expert opinion, not only from the authors but also from a technical expert panel of payment experts who collectively represent the views of informed payers, purchasers, providers, payment administrators, and academic economists and policy analysts. The payment attributes listed, then, reflect the peer-reviewed evidence with its limitations, the authors' experiences, and the panel's the wide and deep expertise, producing consensus judgments as well as informed speculation. We made a special effort to consider not only the effect of payment incentives but also actual implementation, with identification of operational issues and challenges.

The nine payment methods reviewed are a subset of the payment models presented in *A Typology of Payment Methods* (Berenson et al. 2016). As noted in that document, different labels are often applied to one payment method. And there is certainly no best way to organize their presentation. Our payment typology de-emphasizes the sorting of payment methods according to provider type. Yet, given the move toward integrating services across traditional provider silos, some payment methods, in fact, do apply specifically to particular provider types. Accordingly, our nine payment method chapters include provider-specific and generic methods. We also consider payment methods that make base payments to providers and those that provide incremental bonuses and penalties on top of a base payment.

We recognize that listing payment methods as distinct is also somewhat arbitrary. Payment methods can be viewed as falling on a continuum rather than with a clean line separating them. Even a fee schedule for health professionals, often viewed as the prototype of fee-for-service, can include payment codes with elements of both population-based payment and episode-based payment. As we consider designs that attempt to mitigate the weaknesses each payment method exhibits, it becomes clearer that practical application of payment methods often blurs the lines between them. But to

discuss fine distinctions between payment methods, we have elected to review their "purer" forms as the starting point.

A few of the nine payment methods reviewed are long-standing approaches that have been used in different countries and in different markets. Others are more recently proposed approaches, currently undergoing active testing by Medicare, Medicaid, and private payers. Some, such as fee schedules for physicians, are widely, almost ubiquitously, used in the United States and many other countries. Others, such as global budgets for hospitals, are rare in the United States (although global budgets are now being implemented in an all-payer demonstration in Maryland) but have long been in broad use internationally.

Two methods reviewed—per diem payment and payment for hospital stays using DRGs—are by now classic ways of paying hospitals. We include them because their merits can vary in relation to other payment reforms that might be adopted and in relation to benefit designs that affect their operational feasibility. We also include "value-based" payment models being actively tested by Medicare and private payers, including bundled episodes, population-based payment, shared savings, and pay-for-performance. Finally, we revisit primary care capitation, which is being rediscovered as a potential payment reform approach either on its own (with performance reporting) or as a hybrid in conjunction with a reduced price fee schedule.

The impact of any particular payment method will vary based on source of payment (such as private insurance, Medicare, Medicaid, or direct payment by consumers and patients). The clearest example is the discussion of the effect of the payment method on prices. Medicare sets administrative prices whereas private insurance negotiates rates with providers, so the latter is much more dependent on market factors in which the payment methods are adopted. As we review the various attributes of payment methods, where relevant we attempt to distinguish how the method applies to different payers.

We organize the discussion of core attributes of payment methods in the following way:

- **Background information**. An explanation of how the payment method works and relevant experience with the approach
- **Key objectives.** What the payment method is designed primarily, sometimes uniquely, to achieve
- **Strengths.** Both theoretical, incentive-related likely advantages and practical, operational ones

- **Weaknesses.** Both theoretical, incentive-related likely disadvantages and practical, operational ones
- **Design choices to mitigate weaknesses.** Opportunities in actual implementation, largely based on the weaknesses identified, to reduce potential detrimental effects
- **Compatibility with other payment methods and with benefit design options.** Given that any payment method will be strongly interdependent with (1) concurrent methods for the same or related providers and (2) variations in benefit designs, we identify common interactions, both positive and negative. In this section, also, we suggest payment hybrid approaches that are either theoretically appealing based on incentives or are operating in limited areas of the United States or other countries.
- **Focus of performance measurement.** Policymakers and payers have broad interest in being able to measure many aspects of care, perhaps best summarized in the Institute for Healthcare Improvement's Triple Aim goal of simultaneously improving population health, patients' experience of care, and per capita cost. However, we consider measures of these domains of care common for all payment methods here, so we emphasize the vulnerabilities for which performance measurement would be particularly desirable.
- **Potential impact on providers' prices.** Most discussions of payment reform focus on their likely impact on health care costs, not on the impact on prices per se, prices being a major determinant of costs. Often, discussion of costs tends to be dominated by impact on service use; the equally important issue of transaction prices that determine payment amounts is largely neglected. Prices are often unrelated to payment method. For example, a market-dominant health care system can demand high prices whatever the form of payment. However, certain payment approaches have intrinsic features that could affect providers' prices. Note that Medicare sets prices and generally does not negotiate. So we identify and briefly discuss the features that may affect prices for private payers and whether particular market-related features are likely to influence them.

Selected Payment Methods

- Base payments

1. Fee schedules for physicians and other health professionals

2. Primary care capitation
3. Per diem payment to hospitals for inpatient stays
4. Diagnosis related groups-based payment to hospitals for inpatient stays
5. Global budgets for hospitals
6. Bundled episode payments
7. Population-based payments, including capitation

- Incremental payments

8. Shared savings
9. Pay-for-performance

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A technical expert panel advised the project team and reviewed the reports at different stages.

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