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After the Revolution: DRGs at Age 30

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Imagine a government initiative, supported by Republicans and Democrats alike that saved billions of dollars, improved healthcare and was adopted around the world. It happened in 1983 and continues today.

October 1, 2013, marked 30 years since Medicare began paying hospitals by diagnosis-related group (DRG), arguably the most influential innovation in the history of healthcare financing. Initially developed as a tool for hospital management, DRGs became the basis of the inpatient prospective payment system that Medicare implemented in 1983.

The strong incentives were revolutionary in their impact.

Medicare spending growth slowed sharply, and, more remarkable, hospitals posted record profits. After the link between cost and payment was broken, hospitals moved quickly to cut costs. Nevertheless, a literature survey concluded that none of the worst fears about adverse effects on patients were realized.

Diagnosis-related groups have also come to define "the product of a hospital" for purposes of benchmarking and risk adjustment. The acceptance of DRG algorithms owes much to their categorical approach, clinical focus and transparency.

DRG experience today

The two most commonly used algorithms, Medicare DRGs and All Patient Refined (APR) DRGs, typically explain more than 40 percent of cost variance in inpatient stays, although with considerable range by care category. Because Medicare DRGs are unsuitable for obstetrics, pediatrics and neonatology, some payers prefer APR-DRGs.

Diagnosis-related groups have proven to be a suitable basis for payment, as evidenced by widespread use. Common issues include mitigation of adverse incentives, appropriate payment for extremely costly stays, applicability to certain hospitals and care categories and growing complexity.

The DRG experience offers lessons about the effectiveness of financial incentives, the likelihood of adverse effects, the usefulness of casemix measures, the risks of growing complexity and the example that sensible policy need not be the domain of one political party or other entity.