

The Costs and Benefits of Monitoring Providers: Evidence from Medicare Audits*

Maggie Shi [†]

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Abstract

Governments often outsource services to third parties and subsequently monitor them to deter wasteful spending, but monitoring can be costly. This paper studies monitoring in Medicare, where the provision of unnecessary healthcare is a major source of waste. Using novel administrative data on Medicare's largest monitoring program, I study monitoring aimed at detecting and reclaiming Medicare payments for unnecessary hospital admissions. Exploiting plausibly exogenous variation in monitoring intensity across hospitals and across patients, I find that hospitals respond to monitoring by reducing unnecessary admissions, but incur substantial compliance costs to do so. I find no evidence that the marginal patient denied admission is harmed, suggesting that hospitals fine-tune their response to target unnecessary admissions. But in doing so, hospitals' compliance costs increase and they adopt technology to identify unnecessary care. For every \$1,000 in savings to Medicare from monitoring, hospitals incur \$216 in compliance costs. But despite the compliance costs, I find that increased monitoring improves welfare because of the substantial government savings and lack of patient harm.

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[†]Department of Economics, Columbia University. m.shi@columbia.edu