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The MCO Tax:

A Flat Versus Tiered Structure

We have received questions regarding two different approaches to structuring a federally permissible managed care organization (MCO) tax that would meet the state's funding goals. The first approach—proposed by the Governor in his 2015-16 budget—is a tiered tax structure that varies with the size of each MCO's enrollment. (For more information on the Governor's proposal and a discussion of the federal requirements for a permissible MCO tax, see the "MCO Tax Modification" write-up in our February report *The 2015-16 Budget: Analysis of the Health Budget*.) The second approach is a flat tax structure that would impose a uniform tax on each MCO's member-month, irrespective of the size of the MCO's enrollment.

Specifically, we have been asked to comment on the trade-offs between the two approaches in terms of their stability as a revenue source and overall financial burden placed on MCOs. Below is our initial take on how the approaches compare along these criteria.

Revenue Stability

The MCO tax's stability as a revenue source depends in part on whether the tax structure remains federally permissible over time, and how (if at all) the amount of revenue raised is affected by changes in the tax base of MCO enrollment. Compared to a flat tax, the Governor's proposal is significantly more vulnerable on both fronts.

Background. The tax tiers under the Governor's proposal would grant some MCOs a competitive advantage over others, since MCOs competing for the same enrollment would be subject to different effective tax rates on that enrollment, depending on their individual size and degree of Medi-Cal participation. Some MCOs with higher tax rates could cede some of their market share to other MCOs with lower tax rates. A flat tax would not have this effect.

Regardless of which tax structure is in place, there are signs that the MCO industry is already moving toward greater consolidation. For example, two mergers are underway in California that involve MCOs participating in Medi-Cal managed care, and others may follow.

Both tax-induced market changes and ongoing consolidation within the MCO industry could lead to (1) significant shifts in enrollment across MCOs and (2) fewer and larger MCOs operating in the state. The relevance of such shifts to the permissibility and revenue-raising capacity of an MCO tax varies greatly as between a tiered and flat tax.

Federal Permissibility. Specifically, over time, such changes in the distribution of MCO enrollment would lower the likelihood that the initial tax tiers proposed by the Governor would meet federal Medicaid requirements. A uniform tax rate is one of the default federal requirements for a health care-related tax. The state would need to obtain a federal waiver from this requirement to implement a tiered tax structure, demonstrating that the proposal's overall distribution of *gross* tax liability among Medi-Cal and non-Medi-Cal MCOs is similar to that of a uniform tax structure. The administration designed the tax tiers in the Governor's proposal to satisfy this waiver requirement, based on *point-in-time* data on the distribution of MCO enrollment. This distribution is not static, however, and the aforementioned changes to MCOs' market shares could translate into major shifts in gross tax liability across the industry, calling into question whether the tax tiers could remain federally permissible. In contrast, under any enrollment scenario, a flat tax by definition would automatically satisfy the default federal requirements for a uniform tax structure.

Revenue-Raising Capacity. Similarly, revenue from a tiered tax structure based on each taxpayer's size of enrollment is vulnerable to shifts in effective tax rates, as taxpayers move between tiers with changes in the enrollment distribution. In contrast, holding *total* enrollment across the MCO industry constant, the total amount of revenue raised by a flat tax does not vary with the size, number, or composition of each individual MCO.

Thus, compared to a flat tax, a tiered tax is significantly less predictable as a revenue source—as well as more complicated to administer—due to its competitive effects on the MCO market and the potential need to revise the tax tiers and seek federal approval in response to changes in the distribution of MCO enrollment.

Overall MCO Burden

The Governor's MCO tax proposal is designed to raise $1.36 billion for the state's use, at a net cost of $660 million to the MCO industry. In contrast, a flat tax raising the same amount for the state's use would have a net cost of over $950 million to the MCO industry. Compared to a flat tax, a tiered tax structured like the Governor's proposal—geared toward imposing the highest *gross* tax burden on the MCOs that participate most extensively in Medi-Cal—will always result in a lower *net* financial impact to the MCO industry *as a whole*. This is because the Medi-Cal program—to a greater extent under a tiered tax system than under a flat one—can pay back MCOs a portion of their gross tax liability through increased Medi-Cal managed care rates, facilitated by the leveraging of federal funds.

Background. Both the tiered and flat tax approaches are economically neutral to MCOs that solely do business in Medi-Cal. Under either tax structure, an MCO that only enrolls Medi-Cal members would receive back all of its tax payments through increased Medi-Cal managed care rates, thus incurring a net liability of zero. In contrast, an MCO with any commercial enrollment would pay tax on that enrollment, but could not be reimbursed for those payments through Medi-Cal managed care. Because many MCOs that participate extensively in Medi-Cal are relatively mid-sized, the Governor's proposal would assess the highest tax tiers upon the middle range of MCO enrollment. As a result, the state's mid-sized MCOs with little or no participation in Medi-Cal would fare the worst financially under the Governor's proposal. These MCOs would face the highest effective tax rates, but would not receive enough reimbursement from Medi-Cal managed care to offset their relatively large gross liability.

Flat Tax Would Cost MCO Industry More... In 2015-16, the Governor's proposal would generate $1.36 billion for the state's use ($1.1 billion to maintain the General Fund offset from the current MCO tax, and $226 million to fund the In-Home Supportive Services restoration). In doing so, the proposal would create a net liability of $660 million for the entire MCO industry, purely through the tax paid on commercial enrollment.

Flattening the tax structure would reduce the individual net liability for the most disadvantaged mid-sized MCOs, but at a more-than-offsetting cost to the rest of the state's MCOs. To generate the same state funding amount of $1.36 billion as the Governor's proposal, a completely flat tax structure would require imposing a uniform tax of $5.66 per member-month. By our rough estimates, this flat structure would create a net industrywide liability of over $950 million for MCOs. In particular, the state's three largest MCOs would owe substantially more tax under a flat structure. The MCO with the largest tax base of enrollment would incur nearly triple the net liability under a flat tax, compared to the Governor's proposal.

...And Leverage Less Federal Funding. For any given tax structure, after accounting for the portion of state funding borne by MCOs in terms of net liability, the balance of funding is provided through federal reimbursement for Medi-Cal managed care rates. This is summarized in the following equation:

Overall state funding = MCO net liability + federal reimbursement

Therefore, to achieve $1.36 billion in total state funding, the Governor's proposal would leverage $700 million in federal funds ($1.36 billion minus $660 million in MCO liability) for the state's use, while a flat tax would leverage $410 million in federal funds ($1.36 billion minus $950 million in MCO liability). In other words, the flatter the tax structure, the more the MCO industry pays in terms of net liability (with mid-size MCOs paying less and larger MCOs paying more)—and by extension, the less the federal government contributes—toward the same overall funding goal for the state.

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