THE 2023-24 MAY REVISION: LAO ANALYSIS OF MCO TAX PROPOSAL

On Monday, May 8, we sent an email with initial thoughts on the administration's revised managed care organization (MCO) tax proposal. Shortly after the release of our email, the administration provided some additional information on the proposed tax, including one of the proposal's two associated trailer bills. Since that time the administration also has released the backup for Medi-Cal's budget estimates, which provides more information on the proposed MCO tax's impact in the budget year.

This email provides our updated analysis on the proposal. It begins with a description of the proposal. Then, it provides our assessment and recommendations.

PROPOSAL

Proposes Renewing and Increasing the MCO Tax. Assuming it is submitted for federal approval by the end of June and it receives such approval, the proposed MCO tax would begin in April 2023 and extend through the end of 2026. (Were submission to the federal government to lag after June, the tax's start date would be delayed at least to July 2023.) As **Figure 1** shows (page 2), the proposed tax shares many features with the most recent version, including: (1) it is enrollment based; (2) rates only apply to one specific tier of enrollment; (3) rates in all years apply to enrollment levels in one base year (the administration would be authorized to change the base enrollment year that is taxed, to the extent it is needed to maintain federal approval); and (4) rates are much higher for Medi-Cal enrollment than for commercial enrollment. Relative to the most recent version, the two key differences in the proposed MCO tax's structure are: (1) Medi-Cal rates are three to five times larger and (2) tax rates are applied to a higher minimum enrollment threshold. The proposed tax also would apply rates on a calendar-year basis, rather

than a fiscal-year basis as in the last tax, as Medi-Cal managed care capitated rates also are set on a calendar-year basis.

Figure 1

Proposed MCO Tax Medi-Cal Rates Much Higher Than Most Recent Version

	Expired 2020 Tax[a]				Proposed 2023 Tax[b]			
	2019-20[c]	2020-21	2021-22	2022-23[c]	2023[d]	2024	2025	2026
Medi-Cal Rate	$40.00	$45.00	$50.00	$55.00	$182.50	$182.50	$187.50	$192.50
Commercial Rate	1.00	1.00	1.50	1.50	1.75	1.75	2.00	2.25

[a] Rates applied to each plan's aggregate monthly enrollment level between 675,001 and 4,000,000 member months during calendar year 2018.

[b] Rates would apply to each plan's aggregate monthly enrollment level between 1,250,001 and 4,000,000 member months during calendar year 2020.

[c] Tax began January 2020 and expired at the end of December 2022.

[d] Tax would begin April 2023 and would expire at the end of December 2026.

MCO = managed care organization.

Projects Substantial Net State Fiscal Benefit and Relatively Low Cost to Health Insurance Industry. As we noted in our previous email, the net state fiscal benefit reflects the total revenue raised by the tax minus the state share of the cost to reimburse Medi-Cal managed care plans for the cost of the tax**.** Though the administration has not released complete back-up information on the tax, it states that the net state fiscal benefit would be $19.4 billion across 2023 through 2026 (with $4.4 billion specifically in 2023-24). According to the administration, on an annual basis the net state fiscal benefit would be $5 billion—more than double the benefit of the most recent version. By contrast, the net cost to the health insurance industry would be $112 million across the tax period ($20 million in 2023-24). On an annual basis, the net cost to the health insurance industry would be in the low tens of millions of dollars, generally comparable to the most recent version of the tax.

Proposes Using Funds for Three Purposes. According to DHCS, the next MCO tax after this proposed one likely will raise significantly less revenue. This is because, according to

DHCS, the federal government has signaled interest in tightening the existing rules around using health care-related taxes to draw down federal Medicaid funds. At same time, the administration desires to take advantage of the large increase in MCO tax funds to augment Medi-Cal's budget. Recognizing these competing factors, the administration proposes three specific uses, as **Figure 2** shows (page 5), and described further below:

- ***Offsetting General Fund Spending.*** The bulk of the net state fiscal benefit in the budget year, as well as a sizable portion of the overall net benefit in subsequent years, would offset General Fund spending in Medi-Cal.

- ***Increasing Provider Payments in January 2024.*** The administration states that it is proposing a second, forthcoming trailer bill to increase base payments for primary care, obstetric, and non-specialty mental health services to 87.5 percent of Medicare's comparable rates beginning January 2024. These increases would effectively eliminate existing longstanding 10 percent base reductions applied to these services (known as "AB 97 reductions"). The 87.5 percent level also would factor existing supplemental payments for these services supported by Proposition 56 funds (in effect, turning these supplemental payments into base payments). The associated cost to increase base payments includes the impact to fee-for-service payments and an estimated corresponding impact to managed care capitated rates. Our understanding is that the proposal commits the net state fiscal benefit to cover the associated cost (around $240 million annually) through 2026-27, the last year of the MCO tax. After this point, the General Fund would absorb this cost on an ongoing basis.

- ***Reserving the Remaining Funds for Future Medi-Cal Augmentations.*** The remaining funds would be set aside in reserve for future augmentations that further

increase Medi-Cal payments to providers or for other activities that promote access and quality or increase provider participation in Medi-Cal. According to the administration, more time is needed to assess the adequacy of overall Medi-Cal provider payments. The proposed trailer bill legislation sets an expectation that the administration submit these proposals as part of the 2024-25 budget process. The administration states that it intends to propose future augmentations that spread out the MCO tax funds over an eight-to-ten-year period. Spreading out the use of MCO tax revenues, from the administration's perspective, lessens the potential fiscal cliff from having smaller versions of the MCO tax in the future.

As with past versions, funds from the proposed MCO tax would be placed in a new special fund (the "Managed Care Enrollment Fund") to help cover the nonfederal share of Medi-Cal spending. The trailer bill legislation also creates a second reserve account (the "Medi-Cal Provider Payment Reserve Fund") for the future Medi-Cal augmentations.

Figure 2

Large Portion of Tax After Budget Year Would Be Reserved for Future Augmentations

Uses for Net State Fiscal Benefit of Proposed MCO Tax (In Billions)

	Amount in 2023-24	Total Across Tax Period
Offset Medi-Cal General Fund spending	$3.4	$8.3
Increase provider rates in January 2024[a]	0.1	0.8
Reserve for future augmentations[b]	0.9	10.3
Totals	**$4.4**	**$19.4**

[a] Includes $8.9 mllion in 2023-24 (total across period not provided in existing back-up materials) for base provider rate increases proposed at Governor's budget.

[b] To be determined as part of 2024-25 budget process, with funds to be spent over an eight to ten year period.

MCO = managed care organization.

ASSESSMENT

Tax Continues to Warrant Strong Consideration. Given the substantial fiscal benefit to the Medi-Cal program, as well as the relatively low cost to the health insurance industry, renewing and increasing the MCO tax continues to warrant serious legislative consideration. Moreover, this is a particularly opportune time to pursue a new and increased tax in light of the state's current budgetary constraints.

Proposed Augmentations Come With Major Fiscal Tradeoff. While the desire to use a portion of MCO tax funds to augment Medi-Cal's budget is understandable, the administration's proposal comes at a time when the state faces notable fiscal constraints. Our office's analysis suggests that the administration's General Fund revenue projections are optimistic. Under our revenue estimates, collections from the state's three largest taxes—personal income, corporation, and sales—would be $11 billion lower through 2023-24. Moreover, under the administration's own estimates, there are notable deficits throughout the multiyear period. Given this constrained fiscal environment, major augmentations to the Medi-Cal program warrant caution. By committing a portion of the MCO tax for augmentations, the Legislature would have less flexibility to adjust spending priorities were the state's budget situation to further deteriorate. Moreover, to the extent the administration intends to propose ongoing augmentations and the increased MCO tax structure is not a permanent arrangement, the proposed augmentations create ongoing budget pressure in future years. We also emphasize that allocating more funding toward addressing the budget problem does not necessarily mean the MCO tax does not benefit Medi-Cal. Rather, using the MCO tax in this way would further protect Medi-Cal were the state's fiscal situation to worsen.

Limited-Term Augmentations, Rather Than Ongoing Augmentations, Could Help Mitigate Fiscal Risks of Proposal. To the extent the Legislature is interested in using some of the MCO tax's net fiscal benefit to augment Medi-Cal, it could explore limited-term approaches in lieu of ongoing approaches. For example, the Legislature could adopt limited-term supplemental provider payments, rather than ongoing base rate increases, as a means of bolstering Medi-Cal. The Legislature could still spread these payments over a similarly long period of time. In taking this approach, the Legislature would be in a better position toward the end of associated MCO tax funding period to assess the impact of these payments on access and quality of services. The Legislature also would have the benefit of knowing whether the federal government has tightened its rules on the MCO tax and the state's budget capacity in the future, allowing it to make more informed decisions around making these payments permanent. Other possible limited-term uses of these funds outside of provider payment increases could include supporting infrastructure grants to providers, piloting new service delivery approaches, or maintaining a Medi-Cal-specific reserve for economic uncertainty.

More Analysis Warranted to Determine Specific Provider Payment Increases. As we noted in our last email on the MCO tax, we are not aware of comprehensive analysis gauging the adequacy of Medi-Cal payments among the various provider types. For this reason, the administration's approach of deferring decision on most of the payment increases, pending further analysis, would be warranted.

Critical Details of Proposal Remain Missing. While the administration has provided the Legislature more information on its MCO tax proposal, key information continues to remain missing. Most notably, the administration has not shared an analysis demonstrating the tax meets key federal rules. This analysis is important because it provides the Legislature more confidence

that the tax stand a reasonable chance of receiving federal approval. This is particularly critical given the revenues from the tax represent one of the larger budget solutions. Typically this analysis also provides key information on each plan's taxable enrollment level, each plan's tax liability, and overall MCO tax revenues each year. In addition, the administration has not provided year-by-year estimates and projections of the proposed tax's overall revenues and Medi-Cal cost (both state and federal share) to cover the cost of the tax to Medi-Cal managed plans. Moreover, as of the time of this email, the administration has not released the proposed trailer bill legislation for the proposed initial round of provider rate increases.

RECOMMENDATIONS

Direct Administration to Provide More Information on Proposal. We recommend the Legislature continue to work with the administration to obtain complete information about this proposal. Such information should include the outstanding items we describe earlier. Given the tight June 30 deadline to submit the tax to the federal government for approval, the Legislature likely will want to treat this matter with urgency.

Weigh Uses of MCO Tax Funds Carefully. Given the state's tight fiscal situation, we recommend the Legislature take caution in committing to augment Medi-Cal's budget. To the extent the Legislature desires to augment the Medi-Cal budget, we recommend focusing on limited-term uses instead of ongoing uses, such as adopting limited-term supplemental payments instead of ongoing base rate increases. To the extent the Legislature uses the funds for supplemental payments, it could weigh whether to make these payments ongoing in future, once the MCO tax funds have been spent and an analysis of their impacts can be assessed.

Adopt Parameters for Administration's Analysis of Provider Rate Adequacy. As we noted in our last email, we recommend the Legislature direct the administration to release its

assessment of provider payment adequacy by around the time of the release of the Governor's budget (in time to help inform 2024-25 budget decisions). We also recommend setting forth key parameters for the administration's assessment. At a minimum, such parameters could include: (1) average Medi-Cal fee-for-service and managed care base rates and supplemental payments by provider type, both in levels and as a percentage of Medicare payment levels; (2) trends in beneficiary access and utilization of services by provider type and region; and (3) analysis assessing the potential impact of payment increases on beneficiary access and utilization of services.