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The MCO Tax: A Flat Versus Tiered Structure

LEGISLATIVE ANALYST'S OFFICE

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Second Extraordinary Session

Hon. Ed Hernandez, Chair

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Overview of Presentation

- **Review of Two Options for a Managed Care Organization (MCO) Tax—Governor's Tiered Tax Proposal and Flat Tax Alternative**

- **Comparing Two Structures in Terms of Revenue Stability**
  - MCO market changes.
  - Federal permissibility.
  - Revenue predictability.

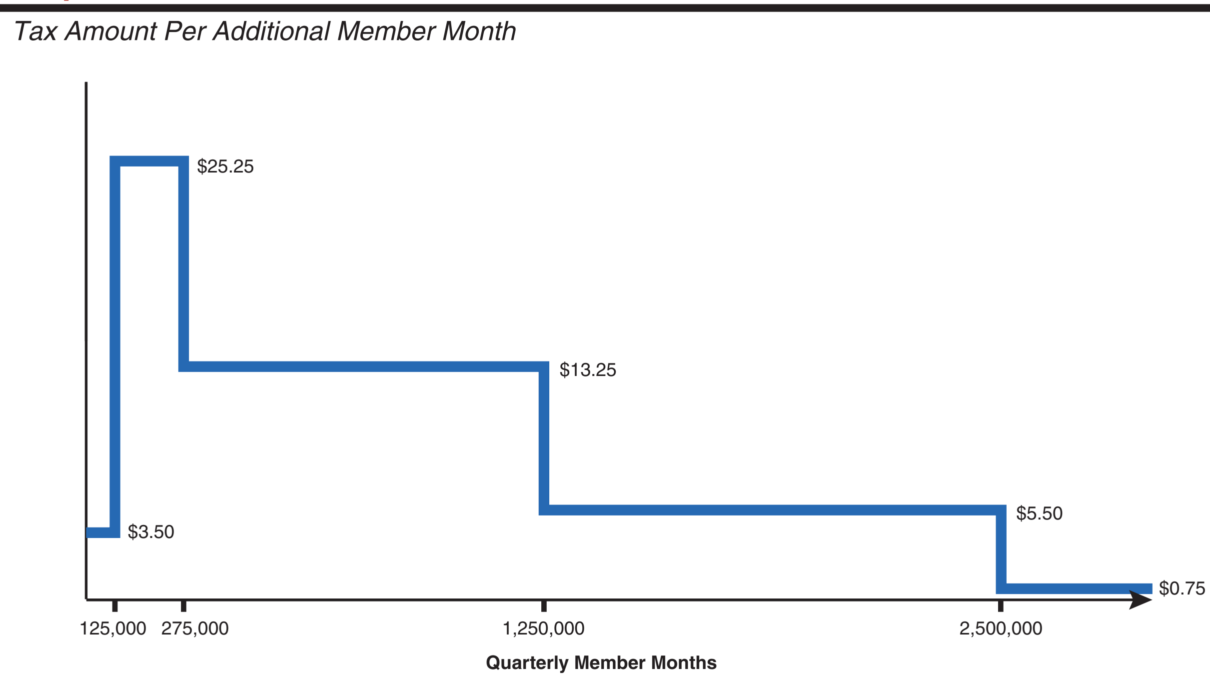
- **Comparing Two Structures in Terms of Who Bears the Tax Burden**
  - Bottom-line comparisons.
  - Total and distributional impact of tiered tax.
  - Total and distributional impact of flat tax.

- **Recap of Trade-Offs—Tiered Versus Flat Structure**

Review of Two Options for MCO Tax Structure

☑ ***Governor's Proposal—A Tiered Tax.*** The Governor proposed a *tiered* MCO tax structure based on enrollment size. The tax per unit (quarterly member months of enrollment) rises, then falls with increasing MCO enrollment. As an example, an MCO with 1 million taxable member months would pay $3.50 per unit for the first 125,000 member months, $25.25 per unit for the next 150,000 member months, and $13.75 per unit for the remaining 725,000 member months, resulting in a total payment of $14.2 million for the quarter. The figure below shows the tax tiers and the per unit tax amounts under the Governor's proposal for 2015-16.

Proposed Tiered Tax Per Additional Member Month in 2015-16



☑ ***One Alternative—A Flat Tax.*** Another approach is a *flat* tax structure that would impose a uniform tax on each MCO's member month, with the tax per member month not varying based on the total size of enrollment.

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Review of Two Options for MCO Tax Structure *(Continued)*

☑ ***Commonalities.*** As enrollment-based taxes, the two approaches share the following key characteristics.

- ***For Tax Paid on Medi-Cal Lives, State Can Hold MCOs Harmless . . .*** According to the administration, the state can build the cost of the tax—whether a tiered or flat structure—for each Medi-Cal enrollee into the MCOs' Medi-Cal managed care rates. This would effectively reimburse MCOs—and hold them harmless—for the portion of tax paid on Medi-Cal lives.

- ***. . . And Leverage Federal Funds.*** The federal government matches the above state reimbursements for the Medi-Cal portion of the tax, thereby providing additional funding for the state's use.

- ***Neither of Above Is Possible for Tax Paid on Commercial Lives . . .*** For each member enrolled in commercial coverage, MCOs under either tax structure would owe tax, but could *not* be directly reimbursed for that tax due to federal restrictions. Because the state cannot provide Medi-Cal reimbursement for commercial tax payments, it cannot leverage federal matching funds through these payments.

- ***. . . Meaning MCOs Would Likely Pass Tax Onto Commercial Purchasers.*** In economic terms, either a tiered or flat tax would function as an effective tax on MCOs' *commercial* coverage. In the long term, purchasers of commercial coverage—including the state as an employer—would likely bear some of the tax through higher premiums.

☑ ***Differences.*** The two approaches differ in the size and distribution of the net financial impact borne by MCOs, purely through the tax paid on commercial coverage. The remainder of this presentation discusses the causes and potential consequences of these differences, starting with a comparison of the two approaches in terms of stability as a revenue source.

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Revenue Stability: MCO Market Changes

☑ ***Enrollment Shifts Across MCOs.*** The tax base for both proposals—commercial and Medi-Cal MCO enrollment—may shift significantly across MCOs over time, thereby potentially affecting the stability of the MCO tax as a revenue source. Some shifts could directly result from imposing a tiered MCO tax like the Governor's proposal, while others (such as mergers between MCOs) may occur regardless of which (if any) MCO tax structure is in place.

- ***Tiered Tax Could Induce Market Changes.*** The tax tiers under the Governor's proposal would grant some MCOs a competitive advantage over others in the commercial market. Different-sized MCOs competing for the same commercial enrollees would owe different taxes on those enrollees—ranging from $0.75 to $25.25 per member-month—making it more expensive for some MCOs to provide commercial coverage than for others. Some MCOs facing higher tax rates could cede their commercial market share to other MCOs with lower tax rates. A flat tax would not have this effect.

- ***MCO Mergers.*** The MCO industry is already moving toward greater consolidation. Several mergers are underway in California that involve MCOs participating in Medi-Cal managed care, and others may follow.

☑ ***Enrollment Shifts Would Render Tiered Tax Less Stable Than Flat Tax.*** An MCO tax is more stable as a revenue source if—over time and under various scenarios—(1) the tax remains federally permissible and (2) the amount of revenue raised by the tax remains predictable. On both criteria, enrollment shifts across MCOs would render a tiered tax like the Governor's proposal much less stable than a flat tax. Next, we explain why this is the case.

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Revenue Stability: Federal Permissibility

- ☑ ***Federal Waiver Necessary for Tiered Tax.*** Federal Medicaid rules require that health care-related taxes be *uniform*—meaning the taxes are applied at the same rate for all taxpayers—unless the state obtains a federally approved waiver from this requirement. Because a tiered MCO tax is by definition non-uniform, a waiver would be necessary to implement this approach. The waiver would have to demonstrate that under the tiered tax, the overall distribution of *gross* tax liability between Medi-Cal and non-Medi-Cal MCOs is similar to that of a uniform tax.

- ☑ ***Governor's Proposal Is Based on Past Enrollment, Which May Change . . .*** The administration designed the tax tiers in the Governor's proposal to satisfy the waiver requirement, based on past *point-in-time* data on the distribution of MCO enrollment. As discussed earlier, this distribution may change for various reasons, including tax-induced market changes and MCO mergers.

- ☑ ***. . . Triggering Need to Revise and Resubmit Tax Tiers for Federal Approval.*** Because the tax tiers are based on enrollment size, shifts in enrollment would translate into shifts in gross tax liability across MCOs. This calls into question whether the tax tiers under the Governor's proposal could remain federally permissible over time. Potentially, there could be a recurring need for the state to revise the tax tiers and resubmit them for federal approval—as frequently as on an annual basis—in response to ongoing changes in the distribution of MCO enrollment. This would complicate the state's ability to effectively administer the tax.

- ☑ ***No Waiver Necessary for Flat Tax.*** A flat tax is by definition uniform, and would automatically satisfy the default federal requirements for a uniform tax structure. Under any enrollment scenario, there would be no need to obtain a waiver, and the flat tax would remain federally permissible, in terms of meeting the uniformity requirement.

Revenue Stability: Revenue Predictability

- ***Total Tiered Tax Revenue Is Highly Sensitive to Enrollment Shifts . . .*** MCO mergers and other market changes could lead to fewer and larger MCOs operating in the state. Under a tiered tax system based on enrollment size, these changes could also cause some MCOs to move between tax tiers. The amount of revenue raised by the tiered tax could be highly sensitive to such shifts. Because the highest tax tiers are assessed upon the middle range of enrollment—and the lowest tiers are assessed upon the highest levels of enrollment—the result could be a tiered tax that raises far less revenue than projected. (For example, the same enrollee that would have been taxed $25.25 when added to a mid-sized MCO would only be taxed $0.75 when added to a much larger MCO.)

- ***. . . While Total Flat Tax Revenue Is Completely Insensitive to Enrollment Shifts.*** 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 or number of MCOs. This is because the uniform tax owed on any given enrollee would remain the same—regardless of whether that enrollee belonged to a small, medium, or large-sized MCO.

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Tax Burden: Bottom-Line Comparison

☑ **An Example: Raising $1.36 Billion for the State's Use**

- ***Governor's Proposal.*** The Governor's MCO tax proposal is designed to generate $1.36 billion for the state's use—$1.13 billion to maintain the General Fund offset from the current MCO tax, and $230 million to fund the In-Home Supportive Services service-hour restoration—at an annual net cost of $670 million to the MCO industry. We estimate the annual net liability for the state's three largest MCOs would be $265 million.

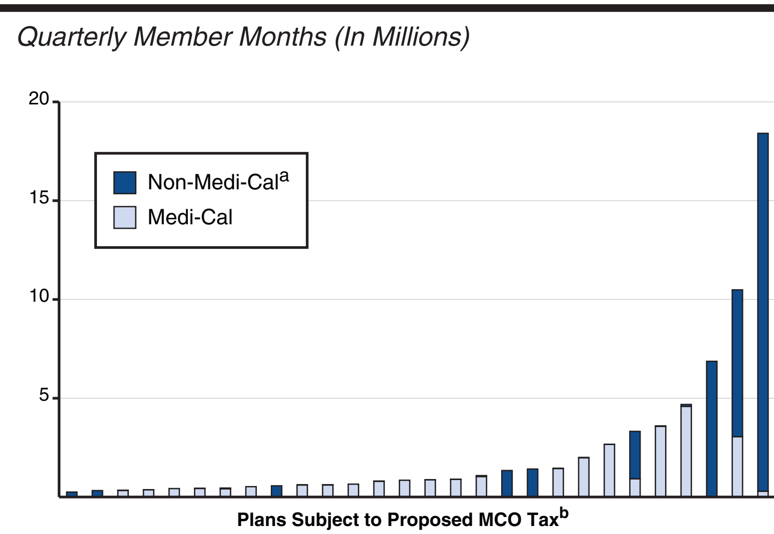
- ***Flat Tax.*** To generate the same state funding amount of $1.36 billion as the Governor's proposal, a flat tax structure would require imposing a uniform tax of $5.66 per member-month. We estimate this flat structure would create a net industrywide liability of over $950 million, with an annual net liability of $800 million for the three largest MCOs.

☑ ***Summary of Comparative Tax Burden.*** For a given funding target, 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 (1) the MCO industry *as a whole* and (2) the largest MCOs in particular. Because the largest MCOs provide the bulk of health coverage for state workers and retirees, state budgetary spending on these benefits may be higher under a flat tax than a tiered tax. Next, we explain each of these issues.

Tax Burden: Total and Distributional Impact of Tiered Tax

☑ ***A Tiered Tax Maximizes Federal Funds . . .*** Many MCOs that participate extensively in Medi-Cal managed care are mid-sized. The Governor's tiered tax structure is thus intended to place a greater share of the tax's *gross* burden on mid-sized MCOs, since much of their tax assessment would be related to Medi-Cal enrollees. As discussed earlier, the state can reimburse MCOs for taxes paid on Medi-Cal lives, which in turn leverages federal matching funds. The figure below shows the current distribution of plans subject to the Governor's proposed MCO tax, by size and Medi-Cal share of enrollment.

Distribution of MCOs by Size and Medi-Cal Share of Enrollment



[a] Excludes Medicare and plan-to-plan enrollment, which are exempt under proposed tax.

[b] Each column represents a different MCO's enrollment, as reported to the Department of Managed Health Care in the third quarter of 2014.

Note: Figure excludes 11 MCOs with fewer than 250,000 quarterly member months of enrollment.

MCO = managed care organization.

Tax Burden: Total and Distributional Impact of Tiered Tax (*Continued*)

☑ ***. . . While Minimizing Total Industry Impact.*** The state's reimbursement to MCOs for the Medi-Cal portion of the tax helps minimize the net tax liability across the *entire* industry.

☑ ***Distributional Impact: Certain Mid-Sized MCOs Are Hit Hardest.*** Under the Governor's approach, some individual MCOs would face a disproportionate share of net tax liability for the following reasons.

- ***Low Medi-Cal Participation.*** These MCOs have little or no Medi-Cal enrollment, and therefore can receive little or no state reimbursement to offset their tax liability.
- ***Face Highest Tax Tiers.*** These MCOs are also mid-sized, meaning they have enough enrollment to be subject to the highest tax tiers, but not enough to reduce their average tax rates through the lowest tax tiers.

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Tax Burden: Total and Distributional Impact of Flat Tax

☑ ***Basic Funding Equation.*** For a given MCO tax structure—after accounting for the federal matching funds leveraged through the state's reimbursement of the Medi-Cal portion of the tax—the balance of the state's funding goal would be borne by MCOs in terms of net financial liability. This is summarized by the following equation.

Overall state funding – federal funds = MCO net liability

We use this equation to calculate the net MCO liability under the Governor's proposal.

$1.36 billion – $690 million federal funds = $670 million MCO net liability

Funding Flow and Impact of Governor's Proposed MCO Tax in 2015-16

Inflows/(Outflows), (In Millions)

State Funding Flow	Special Fund	General Fund	Federal Funds
Capitation increases for Medi-Cal managed care	—	($371.7)	($690.3)
MCO tax revenue collection	$1,733.2	—	—
IHSS restoration	(228.0)	—	267.5
Reimbursement of General Fund for capitation increases	(371.7)	371.7	—
Reimbursement of General Fund for other Medi-Cal costs	(1,133.1)	1,133.1	—
Financial Impact to MCOs	**Gain/ (Loss)**		
Capitation increases for Medi-Cal managed care	$1,062.0		
MCO tax revenue collection	(1,733.2)		
Net Impact to MCOs	**($671.2)**		

IHSS = In-Home Supportive Services and MCO = managed care organization.

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Tax Burden: Total and Distributional Impact of Flat Tax *(Continued)*

☑ ***Flattening the Tax Structure Would Have Several Major Effects.*** Compared to the tiered structure under the Governor's proposal, a flat structure would impose a single unit tax that is lower than the tiers for mid-sized enrollment, but higher than the tiers for large-sized enrollment. For example, a $5.66 flat tax is lower than the $25.25 mid-sized tier—and higher than the $0.75 large-sized tier—under the Governor's proposal. Thus, flattening the tax structure would have several major effects.

- ***Leverage Less Federal Funding.*** Because flattening the tax would lower the tax rate on mid-sized MCOs, it would also lower the following: (1) the tax paid on Medi-Cal enrollment (since MCOs participating in Medi-Cal tend to be mid-sized), (2) the state's reimbursement to MCOs for this Medi-Cal portion of the tax, and (3) federal matching funds for this reimbursement. For example, while the Governor's proposal would leverage $690 million in federal funds, a $5.66 flat tax (which would generate the same amount of funding for the state's use) would leverage only $410 million in federal funds.
- ***Greater Industrywide Cost.*** Because a flat tax leverages less federal funds, a greater portion of the state's funding goal would be borne by MCOs in terms of net liability. We use the same equation to calculate the net MCO liability under a $5.66 flat tax.

  $1.36 billion – $410 million federal funds = $950 million MCO net liability

  In general, flattening the tax structure would reduce the individual net liability for the most disadvantaged mid-sized MCOs under the Governor's proposal, but at a more-than-offsetting cost to the rest of the state's MCOs, creating a greater overall liability for the industry relative to the Governor's proposal.

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Tax Burden: Total and Distributional Impact of Flat Tax *(Continued)*

- ***Shift Burden From Mid-Sized to Large MCOs—and Possibly the State.*** Because a $5.66 flat tax is substantially higher than the $0.75 large-sized tax tier under the Governor's proposal, the state's largest MCOs would owe substantially more tax under a flat structure. As these MCOs provide most of the state's health coverage for workers and retirees, flattening the tax could result in greater costs being passed onto the state through employer health insurance premiums. The figure below compares the net tax liability for select MCOs under the Governor's proposal versus a $5.66 flat tax alternative.

Tiered Versus Flat Structure: Comparing Net Impacts on Select MCOs

(In Millions)

	Net Liability—Tiered Tax[a]	Net Liability—Flat Tax[b]
Large MCOs		
MCO A	$24.3	$183.3
MCO B	118.4	210.3
MCO C	122.8	410.2
Mid-Sized MCOs With No Medi-Cal Enrollment		
MCO D	32.9	12.8
MCO E	14.4	5.7

[a] Assumes tax tiers under Governor's proposal.
[b] Assumes $5.66 uniform tax per member-month.
MCO = managed care organization.

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Tax Burden: Total and Distributional Recap of Trade-Offs

Recap of Trade-Offs Between Tiered Versus Flat Structure

	Tiered Tax	Flat Tax
More Stable in Terms of . . .		
Federal permissibility		✓
Revenue predictability		✓
Minimizes Tax Burden On . . .		
Total MCO industry	✓	
Mid-sized MCOs with low Medi-Cal enrollment		✓
Large MCOs	✓	
State worker and retiree health benefits	✓	
Other Criteria		
Simpler to administer		✓
Maximizes federal funds	✓	
Minimizes unintended market consequences		✓

Note: For each criterion listed, the check mark indicates which of the two tax structures would generally perform better.

MCO = managed care organization.