

Critical MCO Tax Funding That Supports Medicaid Is Longstanding, Legal, and Vetted by Federal Regulators

Background

California's tax on managed care organizations (MCOs) has been in place for more than a decade, and is similar to health care-related taxes used to support health care services that are levied in 49 other states.

In November 2024, California voters overwhelmingly approved, with 67% supporting, Proposition 35 — a ballot measure to make permanent the state's MCO tax. In doing so, they secured ongoing funding for health care services for Californians covered by Medi-Cal. The ballot measure also detailed how these funds would be allocated to support various health care services.

Federal Legal Authority for Health Care-Related Taxes and Directed Payments

Proposition 35 funding is made possible through the existing MCO tax, known under federal Medicaid law as a "health care-related tax." Health care-related taxes are a widely used and approved mechanism in nearly every state — both red and blue — and have been in place for years.

The Social Security Act and regulations from the Centers for Medicare & Medicaid Services (CMS) permit states to levy health care-related taxes on certain classes of providers, including MCOs, to fund Medicaid services, provided these taxes meet certain requirements as determined by CMS. All such taxes — including those imposed on MCOs like the one in California — have been routinely approved and renewed by CMS through both Democratic and Republican administrations.

LAWS AND REGULATIONS AUTHORIZING MCO TAXES

MCO taxes are directly authorized under Section 1903(w) of the Social Security Act and CMS implementation regulations (42 C.F.R. §§ 433.50 through 433.74).

Most, if not all, of Proposition 35's revenue to support hospital care will flow through the Medi-Cal managed care delivery system via a CMS-established mechanism known as "directed payments," in alignment with Code of Federal Regulations (C.F.R.) Title 42 Section 438.6(c). This regulation allows states, with CMS approval, to direct MCO expenditures toward advancing vital health care objectives, including support for provider reimbursement to ensure hospitals receive fair and sustainable compensation for the essential services they provide.

Importance of Proposition 35 for Californians

Proposition 35 provides critical resources to strengthen hospital care across the state. Starting in calendar year 2025, this will fund key hospital services and functions for patients, including:

- Emergency department care
- Outpatient hospital services
- Behavioral health services
- Public hospital support
- Graduate medical education programs
- Critical workforce investments