

LEGISLATIVE UPDATE



Week of May 18, 2026

State Issues

Budget Update:
New MCO Tax
Proposal

This week, we learned more about a major component of Governor Newsom’s plan to secure more revenue for the State. As part of the May Revise, the Governor noted that he expects to bring in \$2.3 billion from a renewed Managed Care Organization (MCO) Tax but did not include any real detail about that proposal. As part of the Assembly Budget Subcommittee hearing on Health held earlier this week, Department of Health Care Services Director, Michelle Baass, shared more about the plan. Following is some background, with details of the new plan below:

California has had MCO taxes for year. Since 2005, the state has had a tax on Managed Care Plans, where the cost of the tax is mostly covered by federal Medicaid funds. It brought in new revenue to the State – which in years past was mostly diverted from its health care purpose and used by the Administration to plug holes in the State Budget.

Prop 35 was created to protect MCO funds for health care. In 2024, a coalition of health care providers sponsored a ballot initiative that would set California’s MCO tax in the State Constitution, with the hope of making it more permanent and ensuring the funds raised by the tax went (mostly) to Medi-Cal providers. Even though this plan is now established in our Constitution, it still requires federal approval every few years. The tax was designed to not be uniform – bringing in much more funding from Medi-Cal lives and capping the tax on commercial lives. This allowed the vast majority of the cost to be borne by the federal Medicaid program and not by the health plans. This current MCO tax raises around \$7 billion to \$8 billion annually, is scheduled to expire at the end of 2026.

Congress recently changed federal rules around this kind of tax. In July 2025, Congress passed HR 1, which has become a real threat to the MCO tax. HR 1 prohibits taxes like California’s MCO that are not “uniform” — meaning California can no longer have a tax that treats Medi-Cal lives and Commercial lives at substantially different rates. Because of how Prop 35 sets up our tax, HR 1 would dramatically limit the amount of money California’s MCO tax could raise — raising just tens of millions of dollars annually — if changes are not made.

The Governor’s New MCO Plan

In the May Revise, the Governor proposes two MCO taxes: One that meets Prop 35 standards but will either be drastically limited in how much money it can draw down by federal HR 1, or more likely, simply rejected by the federal government altogether; and, one that is outside of the Prop 35 rules but meets the HR 1 requirements, and brings in around \$2.3 billion.

Most of the funds will not support Medi-Cal. The Governor plans to have \$2 billion of these funds be used to backfill the State General Fund; and, have \$300 million used to support selected Medi-Cal reimbursement rates for a very small group of providers who have already secured rate increases. This undermines the intent of MCO taxes which is to support health care providers (and who are in particular jeopardy right now because of the effects of HR 1, and new restrictions being proposed by the Governor.)

(more)

<p>Budget Update: New MCO Tax Proposal (continued)</p>	<p>Cost of tax will be borne by commercial insurance rates. In addition, the structure of this new MCO would not be covered by federal Medi-Cal funds. Commercial insurance rates paid by the general public will most likely be increased to cover the tax. The LAO estimates that private insurance rates will increase with an average monthly charge of \$8.85 per enrollee. This is a significant increase. The Governor’s plan is simply a different way to tax Californians, making their health insurance more expensive, to address the State’s budget gap.</p> <p>Legislature weighing pros and cons. During the first hearing of this, it was clear the Assembly Members were conflicted: Clearly this would solve some of their budget problems by bringing in new revenue, but it adds a new tax on the average Californian and does nothing to address the state’s over-extended Medi-Cal program.</p> <p>This will be a big topic of conversation in the coming weeks about the value of the shift, the costs to voters, impact on Medi-Cal access, the legal issues, and likelihood of federal approval. The Legislature must deliver an agreed-upon budget by June 15, which is not much time to flesh out all of these complex policy, legal and political issues.</p>
<p>Governor’s New Diaper Program</p>	<p>Just before Mother’s Day, Governor Newsom announced the “Golden State Start” initiative, aimed at providing free diapers to many of California’s new babies. Along with the Secretary of Health and Human Services, Kim Johnson, and Elizabeth Landsberg, Director of the Department of Health Care Access and Information, the Governor announced a partnership with a LA-based nonprofit, Baby2Baby, to provide 400 diapers to every newborn delivered in a participating California hospital at no cost to the family. In this first year, they plan to provide diapers to ¼ of all babies born in the State, increasing that to ½ the babies in subsequent years. (Californians deliver about 400,000 babies per year.) The Governor touts this as part of a broader affordability strategy, which includes CalRx, where the state can leverage its bulk purchasing power to reduce the cost of products – or in this case, initially offer them for free. Baby2Baby created their own diaper manufacturing system, and they say that they can produce diapers for 80% less than retail price.</p> <p>The State will seek to partner with hospitals that see a large Medi-Cal population and rank low on the “Healthy Places Index,” but diapers will be offered to all new moms – regardless of economic status or insurance coverage. Baby2Baby will be responsible for procurement and warehousing the diapers, but it seems hospitals will be responsible for storing the diapers until they are needed. Baby2Baby will work with each hospital to understand their requirements for storage and other logistics for distribution.</p> <p>This diaper initiative was a proposal from the Governor last year and quickly received extensive push back from Legislators who questions the value in giving diapers to all without identifying those in need and the concerns with adding to the duties of hospitals. In addition, the Legislature has clear concerns about the Governor’s decision to provide a sole source contract to Baby2Baby, which has direct ties to First Partner Jennifer Seibel Newsom. The co-CEO of Baby2Baby sits on the board of the nonprofit run by Seibel Newsom. Senator Menjivar noted in the hearing that the optics of the selection of this vendor is good and “not a smart move.” The Board and “Angels” of Baby to Baby is a who’s who of LA celebrity moms.</p> <p>The May Revise allocates \$12.5 million for this program, and the LAO noted that this is the type of new spending program that should be explored as the Legislature will be asked to make cuts to other health care programs. There will be a Town Hall facilitated with the Baby-to-Baby group for hospitals and stakeholders to learn more at the end of May/beginning of June. The Governor has said they hope to have this program rolled out sometime this summer.</p>