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POLICY SPOTLIGHT

Medicaid Financing Reform After the OBBBA

Closing loopholes to restore honesty in Medicaid's state–federal partnership

JACK SALMON | SEPTEMBER 2025

On July 4, 2025, Congress passed, and the president signed, the One Big Beautiful Bill Act (OBBBA), which includes new restrictions on Medicaid provider taxes and state-directed payments. These reforms represent a meaningful step toward curbing long-standing abuses in Medicaid financing. Yet, because the reforms are phased in and leave many existing schemes temporarily untouched, the core problem persists. The analysis below explains how the Medicaid “shell game” works, why it has proven so costly, and why Congress must go further if the program is to serve the vulnerable rather than state budget gimmicks.¹

How the Shell Game Works

For decades, state governments have manipulated the Medicaid funding formula through provider taxes. This maneuver lets states conjure federal Medicaid dollars without real spending, creating a budgetary illusion that undermines both the intent and integrity of the federal–state Medicaid partnership. This is how the shell game works:

- A state imposes taxes or fees on Medicaid providers.
- Providers pay the tax but often get their money right back from the state, either directly through enhanced Medicaid payments or indirectly through supplemental programs and rate increases.
- The state then uses its higher spending to trigger a larger federal matching payment, even though spending was not borne by the state—it was merely the state returning providers' money.

Everyone in the loop wins except the federal taxpayer, who pays for it.

California, for example, has been projected to raise nearly \$20 billion in under four years through its managed care organization (MCO) tax—not by taxing Californians more, but by recycling money from MCOs back to

¹ See Jack Salmon, “End the Medicaid Shell Game,” *The Unseen and the Unsaid*, June 11, 2025. Scan the QR code below for a full analysis and sources.



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MCOs in a way that allows the state to draw more federal matching funds by claiming higher Medicaid spending. California is not an isolated case; as of December 2024 at least 20 states have an MCO provider tax.

Under federal law, provider taxes are legal under the condition that states do not repay the providers who pay the tax. This condition, known as the “hold harmless” rule, has been undermined through technical loopholes, strategic rate design, and a general lack of federal enforcement. Federal regulators struggle to enforce the hold harmless rule, as the federal Centers for Medicare and Medicaid Services (CMS) is hampered by legal ambiguity, complex financial arrangements, and entrenched political interests:

1. **Legal ambiguity** blurs the lines of what constitutes a repayment and makes enforcement difficult.
2. **Complex financial arrangements** obscure the flow of funds.
3. **Entrenched political interests** hinder thorough oversight and protect schemes from scrutiny.

Meanwhile, provider lobbies and state officials who rely on this loop have resisted crackdowns and have left CMS hesitating to act against politically sensitive funding mechanisms. The result is a system where provider taxes are used not to fund healthcare, but to unlock federal money in a circular flow that obscures accountability and undermines the program’s stated purpose.

Why the Shell Game Is Costly

The damage goes well beyond technical concerns about accounting rules.

- The scheme **adds fiscal costs**. It distorts the state-federal fiscal relationship, fuels excess Medicaid payments, and allows state governments to appear fiscally prudent while it outsources the real costs to the federal taxpayer. The Congressional Budget Office estimates that this scheme will cost the federal taxpayer over \$420 billion in the coming decade.
- The shell game **erodes transparency and accountability**.
- It **shifts the focus from care delivery to revenue maximization**, reducing Medicaid’s effectiveness.

What Congress Can Do

Congress took long-overdue action with the One Big Beautiful Bill Act. This legislation includes significant reforms to Medicaid financing, most notably targeting provider tax schemes. The OBBBA freezes the creation of new provider taxes, phases down the “safe harbor” threshold from 6 percent in 2025 to 5.5 percent in 2028 and 3.5 percent by 2032, and caps state-directed provider payments at Medicare-level rates (100 percent in expansion states, 110 percent in non-expansion states), with some exceptions grandfathered until 2028.

But **the OBBBA is only a partial fix**. Its phased rollout leaves old loopholes temporarily open, and provider tax arrangements will continue to distort Medicaid financing in the short run.

Future improvements should not be partisan; they will test whether Congress is willing to defend the principle of fiscal honesty in a program that consumes nearly one-fifth of federal mandatory spending. Congress must recognize that reforming this financing abuse is not about cutting Medicaid, it is about restoring its integrity.