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SENATE HEALTH BILL SCORES BIG FOR SMALL BUSINESS

Bill Would Help Provide Affordable, Stable Health Coverage

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Skyrocketing health care costs in recent years have posed challenges for all businesses, but small firms and their workers are at a particular disadvantage. Declines in insurance coverage among workers in small businesses (especially businesses with less than 10 workers) have driven much of the drop in employer-sponsored health insurance coverage nationwide. It is no surprise then that the effect of health reform on small business has become a flashpoint in the ongoing health reform debate. This brief highlights the challenges faced by small businesses and the positive effect of Senate Majority Leader Reid's health reform bill (as released on November 18, 2009) on the ability of small firms to provide quality, affordable insurance coverage to their workers. It concludes by reviewing evidence from the Congressional Budget Office that shows major savings for many small businesses and their workers.

This brief documents the burden that small businesses face in providing health insurance coverage for their workers:

- Small firms are less likely to offer health insurance to their workers than larger firms. It is dwindling coverage in small firms that is driving much of the national decline in workplace insurance coverage.
- Low coverage rates among small firms are due to many elements that make purchasing insurance much more expensive for small businesses than for larger firms, including an inability to offer attractive risk pools to potential insurers, high administrative and loading costs, and little competition in insurer markets.

This brief also finds that the vast majority of small businesses stand to gain from the legislation currently being considered by the Senate, and that small businesses as a group are some of the largest winners from health reform. Major improvements would include:

- Insurance coverage will become much easier to purchase for small firms with the creation of new regulated insurance markets.
- Insurance costs will become much more stable and predictable for small firms, even if one or more of their workers requires medical care or their workforce size or composition changes from year to year.
- Very small, low-wage firms would see considerable reductions in their premiums due to new tax credits, with savings averaging 8-10% of total premium costs according to the Congressional Budget Office.
- Firms with 50 or fewer workers are not subject to any penalties if they choose not to provide health insurance to their workers.

Challenges faced by small businesses

According to the survey of employers conducted by the Kaiser Family Foundation, only 35% of small businesses (i.e., less than 10 workers) offer health insurance to their workers, compared to 99% of large firms (200 or more workers), and 63% of all firms (Kaiser-HRET 2008). According to the Commonwealth Fund (2007) , over half of the uninsured worker population (14.0 million out of 25.6 million uninsured adult workers) is employed by a small business (less than 50 workers) while small business workers represent about half of all adult workers. The Kaiser-HRET (2008) survey finds that most of the decline in overall ESI offering in recent years has been driven by reduced insurance offering at small firms.

Figure A displays the decline in ones' own employer-sponsored health insurance coverage for workers with a strong attachment to the labor force (defined in this case as private-sector workers who work at least 20 hours per week and 26 weeks per year). While employer-sponsored insurance (ESI) coverage in all firms has declined between 2000 and 2008, coverage rates are strongly associated with firm size. Firms with nine or fewer workers are the least likely to offer coverage, at 27%, as compared to 38% for firms with 10-24 workers, 53% for firms with 25-99 workers, and 66% for firms with 100 or more workers.

Further, even those small firms that do offer health insurance pass on a higher share of the cost of plans to workers; average contributions by workers in small firms are 30% to 45% higher than in larger firms. Small businesses confront these barriers to offering health insurance because of the high costs they incur on the health insurance market, paying on average 18% more than larger firms for identical health insurance policies (Kaiser-HRET 2008). Small firms face these costs for four reasons: higher and more variable health risks; a lack of competition among small-group market insurers; greater administrative expenses; and lower wages.

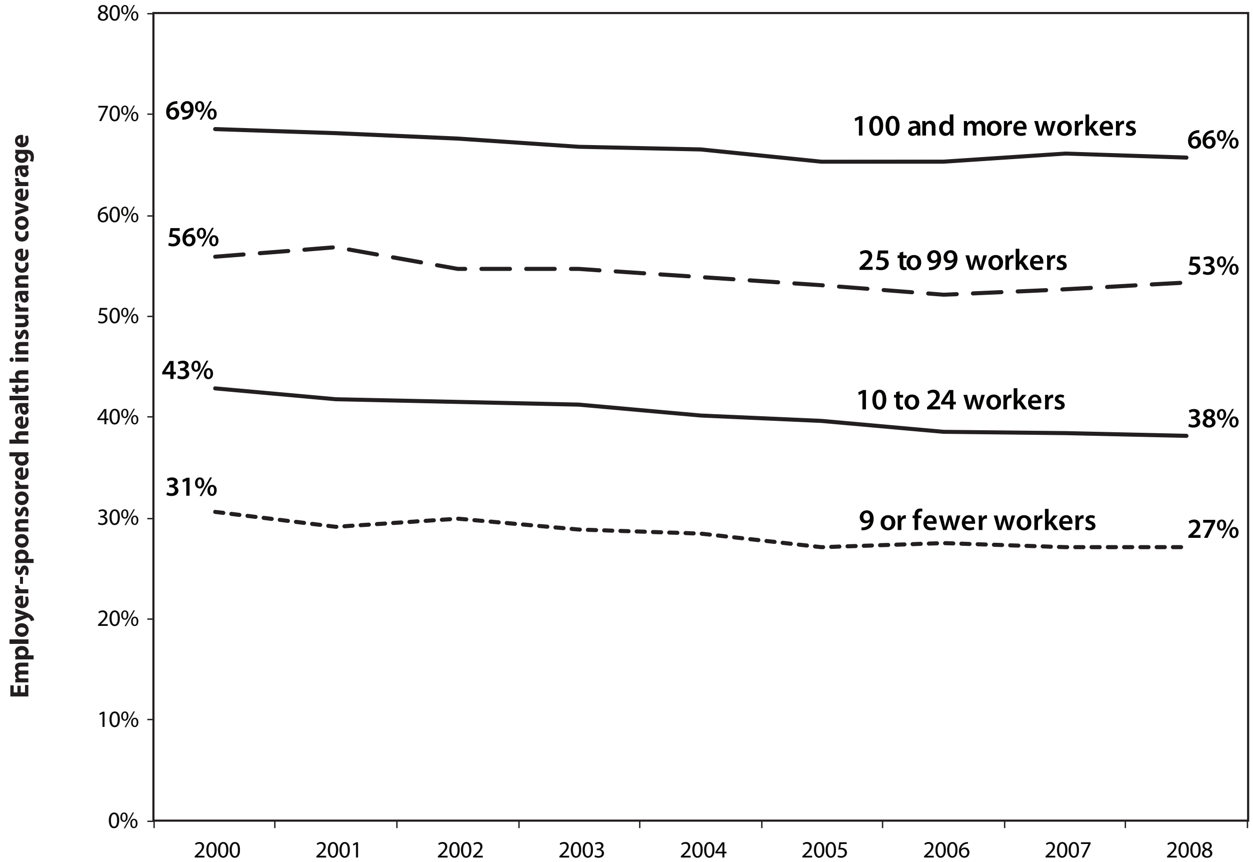
Higher and more-variable risk-rated premiums

Employer-sponsored health insurance is premised on the principle of risk pooling: within a given workplace, premiums from healthy individuals subsidize the medical payments made for individuals who become sick. The larger and more diverse the risk pool, the lower the average risk to the group as a whole and the lower the required premium for any one individual. Given this arrangement, larger firms with a more diverse group of enrolled workers will face much lower costs than smaller firms that do not have as many low-risk workers to balance out workers that may become unhealthy (Gould and Minicozzi 2009).

Not only is the average health risk for the small employer health insurance market likely to be higher (CBO 2009), but it is also more variable given that the average risk can change dramatically from one year to the next as the pool of workers changes. For a small to mid-sized firm, one to five sick workers with high medical costs can account for half of insurance spending (Gabel 2010).

FIGURE A

Worker ESI coverage by firm size



SOURCE: Authors' analysis of Current Population Survey data.

Small firms' potential for high and fluctuating health costs leads health insurance companies to engage in more extensive and frequent medical underwriting relative to larger firms (Harbage and Haycock 2009; Merlis 2009; Zellers et al. 1996). Medical underwriting refers to the evaluation of a firm's potential medical risk, and thus gives insurers the opportunity to charge smaller firms more for the same insurance benefits compared to larger businesses. Underwriting in itself is an expensive process that increases administrative costs, while its outcome can lead to either denial of insurance or higher prices for that population (e.g., the chronically ill) who need coverage the most.

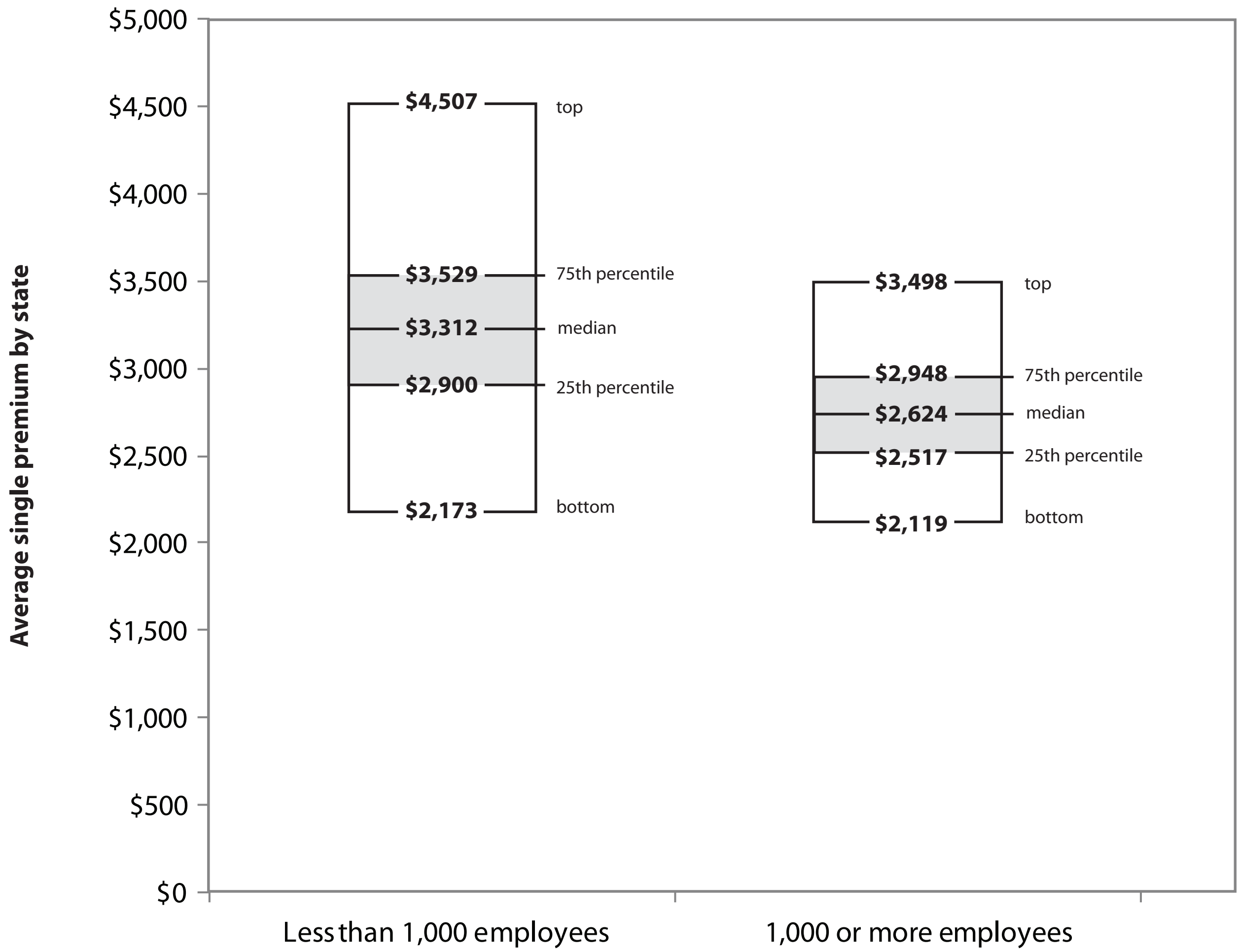
Limited competition

The market for small-group health insurance is often extremely limited; the median market share of the single largest small-firm insurer has increased from 33% in 2002 to 47% in 2008 (GAO 2009). The same study reports that the number of states where five insurers controlled more than 75% of the market has also increased to 34 out of the 39 states examined, up from 19 out of 34 states in 2002. Research has demonstrated that limited competition between health insurance companies reduces incentives for cost control or bargaining with care providers, ultimately raising premiums for small-business owners and their workers (Robinson 2004).

Suggestive evidence that competition in small-employer insurance markets is indeed limited can be seen in the stark geographic variation in premium levels between firm sizes. **Figure B** shows the variation in average single-plan premiums

FIGURE B

Variation in average single premiums across states, by firm size, 2006



SOURCE: Authors' analysis of Medical Expenditure Panel Survey-Insurance Component, 2006.

for firms with less than 1,000 workers and is much greater than for those with over 1,000 workers for each state. Furthermore, limited competition and regulation has allowed insurers to compete based on risk selection—or the ability to select the lowest cost firms—rather than on quality or cost control. Insurers will often attempt to drop "lemon firms"—small employers with higher than expected medical costs (Jost 2009). Recent testimony by Wendell Potter, a former insurance industry executive, has shown that insurance companies will perform frequent risk reviews of firms (particularly small firms) that show increased medical expenses, deliberately raising administrative charges and premiums until the firm is forced to abandon coverage (Potter 2009). Comprehensive national health reform has the potential to lower the cost of offering health insurance for small firms, as well as making the process more transparent and predictable.

High administrative costs

Underwriting and many other costs of issuing health insurance are characterized by economies of scale. Therefore, small businesses face higher administrative expenses per dollar of insurance purchased. While administrative costs account for only 10% of the insurance premiums of larger firms, they represent 20-25% of premium costs for small businesses

(Commonwealth 2009). Small businesses often experience higher staff turnover and cycling of their health insurance compared to larger firms, which also increases their costs of offering insurance (Hope and Mackin 2009; Long and Marquis 2001).

Figure C displays estimates of administrative costs as a share of total claims used by the Lewin Group in their scoring of health reform proposals. This ratio differs by a great amount between the smallest and largest firm. Small businesses should see health reform as a key instrument for leveling the playing field with other firms and should, all else equal, see very large gains from any plan that extends to them the benefits of pooling and lower administrative costs.

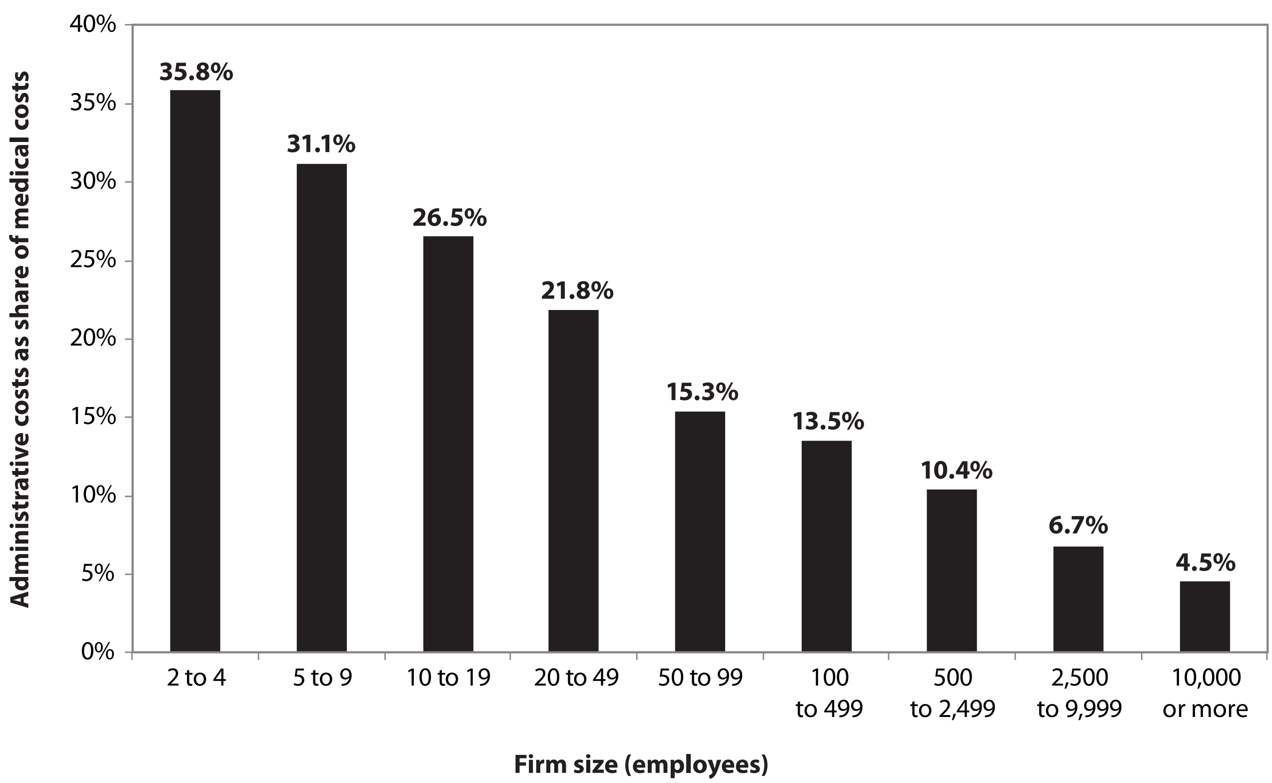
Lower wages

Most economists agree that much, if not all of the cost of providing health insurance to an employee (as with all forms of non-wage compensation) is passed on to the worker through lower wages. That means that, all else equal, a worker who receives health insurance will generally have lower wages than a similar worker without workplace health insurance. Given that the average worker in a small business is paid less than the average worker in a larger firm, low-wage small firms and their employees cannot as easily absorb the costs of offering health insurance (Groshen 1991).

Given these challenges, small businesses require reforms that will improve competition between insurers, grant them more bargaining power, reduce the administrative costs associated with providing insurance, and take into account their payroll size (in addition to the size of their workforce) in crafting reform.

FIGURE C

Administative costs for health insurance, by firm size



SOURCE: Lewin Group analysis of Hacker (2006) *Health Care for America.*

Small business provisions in the Senate health reform bill and their effect on cost and coverage

The Senate health bill, as it was released on November 18, 2009, would restructure the way small businesses and their workers purchase health insurance. See **Table 1** for a summary of the measures in the Senate health reform bill that affect small businesses.

The bill would create new, state-based insurance exchanges where individuals and small- to mid-size employers could easily "shop" for coverage. The exchanges would provide a centralized location where small employers could easily secure coverage and where private insurers would compete with one another (and potentially a public insurer), thereby lowering costs and potentially improving product quality (CBO 2009). The large statewide or regional insurance risk pools created by the insurance exchanges would help alleviate the problem of too-small risk pools that currently occurs in the small group market. Initially, small- and mid-size employers (less than 100 workers) will be able to purchase coverage from the exchanges once they become operational; by 2017, states can allow larger firms to enter.

New regulations would require insurers to offer insurance to all individuals and small firms (guarantee issue) at common rates not based on prior or expected medical needs (community rating), and would prevent insurers from dropping coverage or raising premiums without clear justification. Insurers would also have to establish common sets of benefits that would make coverage more comprehensive and easier to compare among different insurance providers. This would make insurance costs and coverage more stable for small firms and would lower the administrative and underwriting costs currently associated with the small group market.

Although the bill requires firms to offer coverage or pay a contribution toward subsidies for low-income individuals, small firms (with 50 or fewer workers) are exempt from this provision. In fact, firms with 25 or fewer workers and annual average wages of less than $40,000 are eligible for tax credits to assist with providing insurance to their workers. Further, this credit for small businesses phases in before most other aspects of overall reform.

Between 2011 and 2013, these small, low-wage firms are eligible to receive a credit of up to 35% of the employer premium contribution if the employer contributes at least 50% of the total premium cost or 50% of a benchmark premium within the exchange. The full credit would be offered to firms with 10 or fewer workers and average annual wages less than $20,000, and the credit would be phased out as firm size and wages increase. Tax-exempt small businesses (i.e., non-profits) meeting the size and wage requirements are eligible for credits of up to 25% of the employer contribution.

Between 2014 and later years, the same eligible small businesses (with 25 or fewer workers and annual average wages of less than $40,000) that instead purchase insurance through an exchange can receive a credit of up to 50% of the

TABLE 1

Measures in the Senate health reform bill that affect small businesses

Provision	Effect on small businesses
New regulated health insurance "exchanges"	Provides centralized market with competition between private insurers (and potentially a public insurance option) for small businesses to go and comparison-shop for best coverage option for their workers. New insurance regulations in the exchange would make coverage and costs much more stable and predictable for small firms and their workers.
Small business tax credits	Subsidize the cost of providing coverage to workers (up to 35% of costs in early years, and then up to 50% of costs in later years). Would, on average, lower premiums paid by approximately 3 million people by 8-10%.
Small employer exemption	Small employers (50 and fewer workers) are not subject to any penalties if they choose not to provide health insurance to their workers

SOURCE: Authors' analysis of bill language.

employer premium contribution if the employer contributes at least 50% of the total premium cost. Full credit is offered to firms with 10 or fewer workers and average annual wages less than $20,000. Credit phases out as firm size and wages increase. Tax-exempt small businesses are eligible for tax credits of up to 35% of the employer contribution.

According to the Congressional Budget Office, about 12% of people with health insurance from small firms—about 3 million people in 2016—will benefit from the small business tax credits (CBO 2009). On average, the cost of their premiums will be reduced by 8-10%. This amounts to savings of about $702 for single plans and $1,728 for family plans.

WOULD THE INSURANCE MANDATE HURT EMPLOYMENT IN SMALL BUSINESSES AND OTHER FIRMS?

A frequent claim of health reform critics is that an employer requirement to provide insurance coverage will hurt employment, particularly in small firms. This brief finds that claim to be untrue. First and foremost, small employers (with 50 or fewer workers) will be exempt from any penalties if they choose not to provide insurance to their workers. Second, the majority of any increased costs of health insurance can generally be taken out of workers' wages with the exception of minimum wage workers. Last, economic analysis of a more strict mandate (similar to the one passed by the U.S. House of Representatives) found negligible job loss (Cryan 2009). Therefore, the much smaller penalties found in the Senate Leadership health bill are likely to have an even smaller effect.

Conclusion

Small businesses face formidable challenges in purchasing health insurance coverage for their workers and have much to gain from health reform. The Senate Leadership health reform bill, as it is currently formulated, would greatly improve small firms' ability to purchase stable, affordable, and high-quality coverage for their workers by providing both a new regulated, competitive insurance marketplace and tax credits for small, low-wage firms.

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