



## HEALTH CARE REFORM

### Big Benefits for Small Businesses

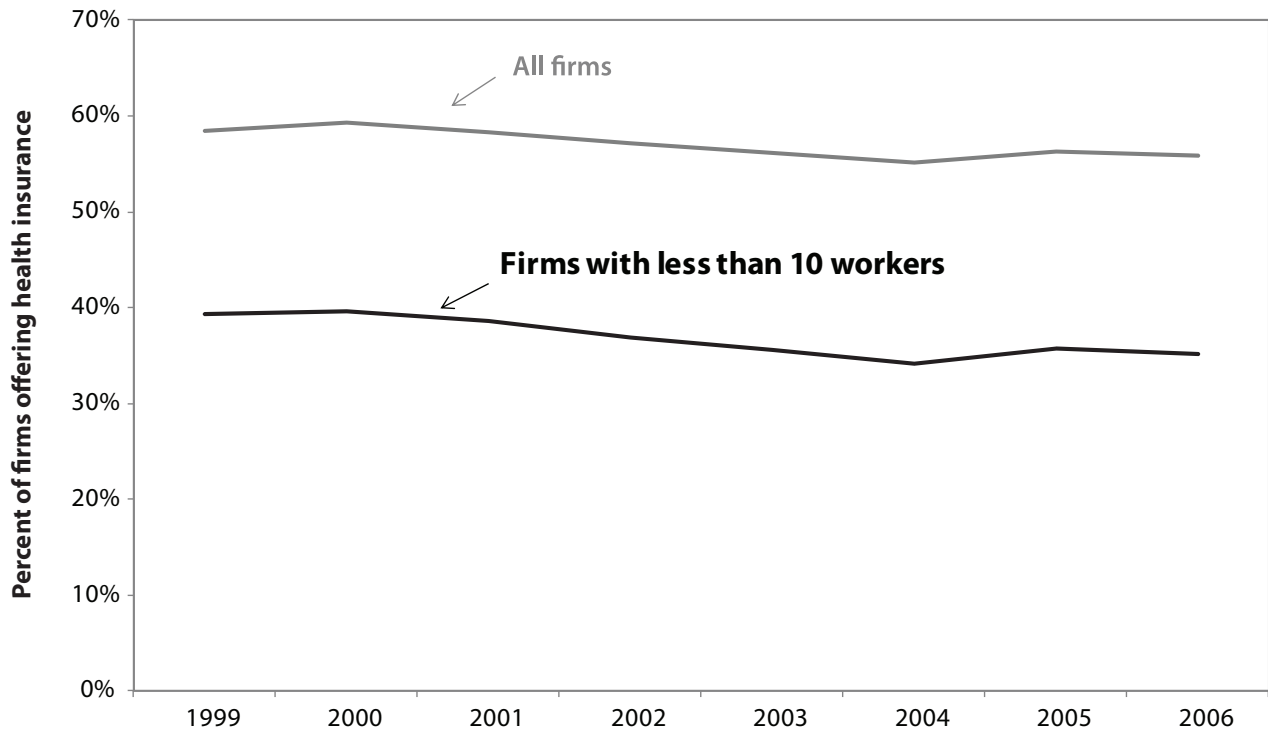
BY JOSH BIVENS, ELISE GOULD, AND ALEXANDER HERTEL-FERNANDEZ

Employer-sponsored insurance (ESI) is the dominant source of health insurance for the non-elderly population in the United States, still covering 62.9% of this group despite consistent erosion over the past eight years (Gould 2008). Furthermore, employer contributions to ESI premiums (\$532 billion in 2008) account for almost a quarter of *all* health spending in the United States, and for roughly one-third of health spending when Medicare (whose spending accrues overwhelmingly to the over-65 population) is excluded. Although increased health care costs have made it challenging for all firms to offer coverage, small businesses are at a particular disadvantage: declines in offers by firms with less than 10 workers have driven much of the overall decline in ESI offers. The implications for small businesses often carry much (perhaps even outsized, given its importance) weight in debates over health reform. This brief highlights the challenges faced by small businesses and the potential for fundamental health reform to greatly improve their ability to offer quality, affordable health insurance to their workers. Its key findings are:

- Small employers offer health insurance to their workers at much lower rates than other employers, and it is this decline that explains much of the erosion in ESI coverage since 2000.
- These low offer rates are due to a number of factors (e.g., insufficient size to offer attractive pools to potential insurers; high administrative costs; and little competition in the insurers' markets) that make purchasing insurance particularly expensive for small firms.
- Small businesses that currently offer insurance are among the biggest potential winners from fundamental health reform—one reform proposal similar to the current House of Representatives Tri Committee Proposal (the Health Care for America plan) predicts costs savings of \$3,500 per worker for small businesses that are currently covering 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)

**FIGURE A****Employers offering health insurance, by firm size**

SOURCE: Authors' analysis of Medical Expenditure Panel Survey-Insurance Component, 1999-2006.

and 63% of all firms (see **Figure A** for details of the declining trends) (Kaiser-HRET 2008). Indeed, nearly half of the uninsured worker population is employed by a small business. The Kaiser-HRET (2008) survey has also shown that most of the decline in overall ESI offering in recent years has been driven by reduced insurance offering at small firms.

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 between 30% and 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). Smaller firms face these costs for four reasons: higher and more variable health risks; a lack

of competition amongst small-group market insurers; greater administrative expenses; and lower wages.

### ***Higher and more variable risk-rated premiums***

Insurance is premised on the principle of risk pooling: within a given “group” or 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 a small health insurance pool likely to be higher, 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. 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; 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

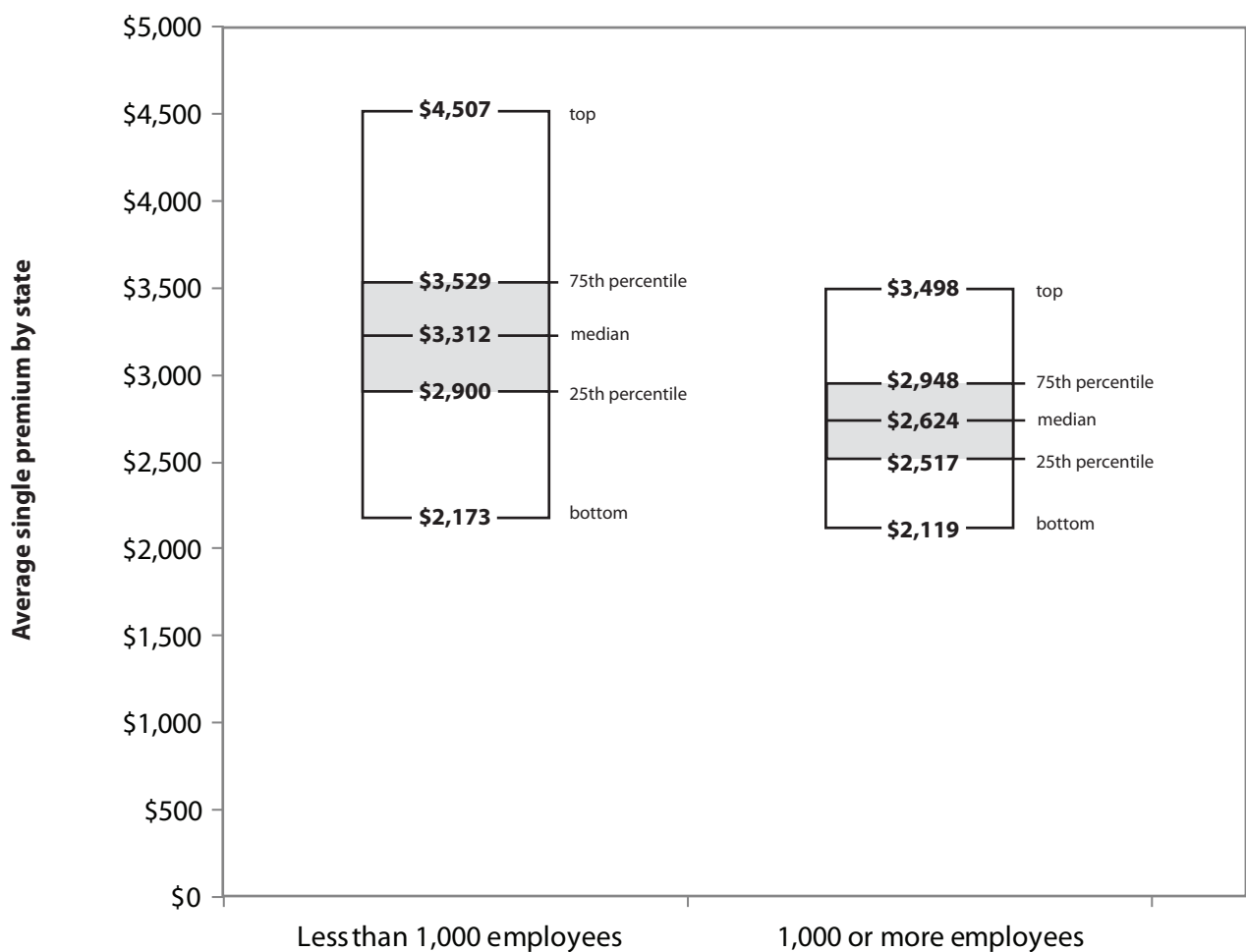
businesses. Underwriting in itself is an expensive process that increases administrative costs.

### **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

**FIGURE B**

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



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

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 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 on the basis of 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

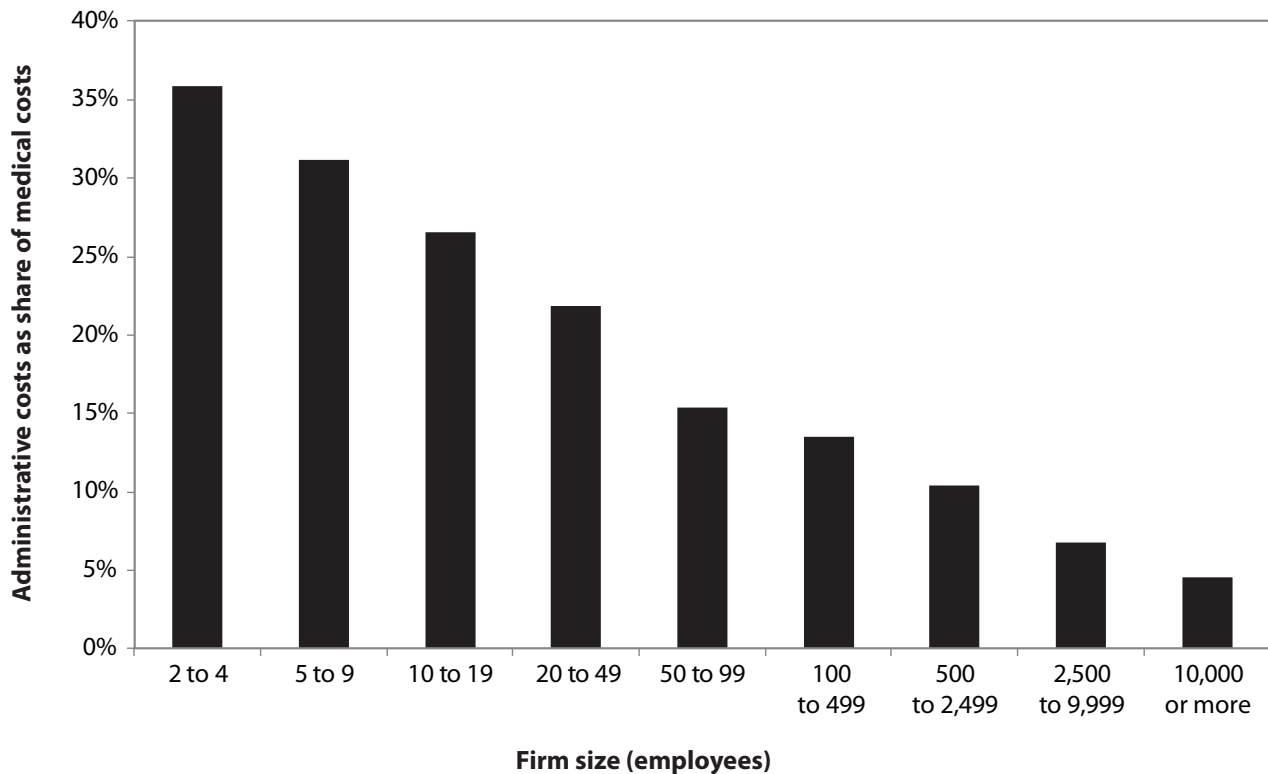
executive, has shown that insurance companies will perform frequent risk reviews of firms (particularly small firms) that show increased medical expenses, deliberately raising administrative charges and premiums until the firm is forced to abandon coverage (Potter 2009). Comprehensive national health reform with a “pay-or-play” model and a public insurance plan option will lower the cost of offering health insurance for small firms, as well as making the process more transparent and predictable.

### **High administrative costs**

Small firms’ potential for high and fluctuating health costs also leads insurance companies to engage in more extensive and frequent medical underwriting relative to larger firms (Merlis 2009). 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

**FIGURE C**

### **Administrative costs for health insurance, by firm size**



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

to larger businesses. As previously mentioned, underwriting is an expensive process that increases administrative costs. Moreover, since underwriting and many other costs of issuing health insurance are characterized by economies of scale, 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** shows the 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 almost an order of magnitude between the smallest

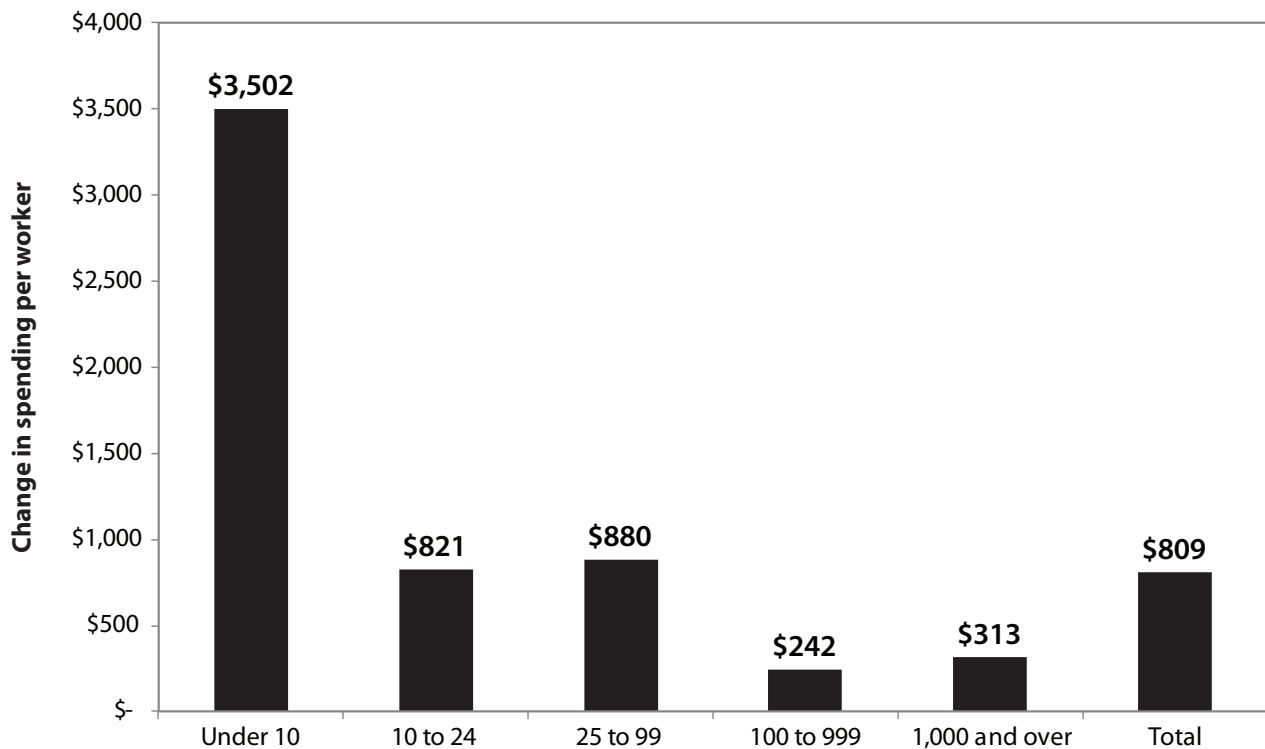
and largest firm sizes. Small businesses should see health reform as a key instrument for leveling the playing field with other firms and should, all else equal, see very large gains from any plan that extends to them the benefits of pooling and lower administrative costs.

### 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 through to the worker through lower wages (Allegretto and Bernstein 2006). That means that a worker that receives health insurance will generally have lower wages than if the worker did not receive 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 (Groschen 1991).

**FIGURE D**

### Projected amount of savings per worker under HCA for insuring firms, by firm size



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

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This also means that in any health reform proposals that mandate a firm's contribution to health insurance be proportional to its payroll, not just firm size, have a potentially important advantage.

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 crafting reform.

## How reform with a hybrid plan could benefit small businesses

There are several proposals for health reform that include a “pay-or-play” component. Under pay-or-play plans, employers must either contribute a specified minimum amount to covering their workers with private ESI plans or pay a mandatory contribution meant to defray the costs of enrolling their employees in alternative coverage. The *Health Care for America* plan, authored by Jacob Hacker for the Economic Policy Institute, is a reform proposal that includes a pay-or-play mandate for employers (setting the mandatory contribution for non-insuring firms at 6% of payroll), a national insurance exchange, and a public plan option. The *Health Care for America* plan bears a strong resemblance to several plans still being considered in the health debate, most notably that of the current House of Representatives' Tri Committee health reform bill.

An independent analysis of EPI's *Health Care for America* plan undertaken by the Lewin Group shows that small businesses who currently provide insurance were some of the biggest winners (Shiels and Haught 2007). **Figure D** shows the projected change in health spending by firm-size for currently insuring firms. Firms that currently offer health insurance with less than 10 workers would save \$3,502 per employee; firms with 10-24 workers would save \$821 per employee; and those with 25 to 99 workers would save \$880 per employee. This would result in savings of over \$30.1 billion for firms offering health insurance with less than 10 workers, and over \$44.7 billion for insuring firms with less than 100 workers.

## Conclusion

The potential windfall savings from fundamental reform have not gone unnoticed by small-business owners. A recent poll by the Mainstreet Alliance found that 59% of small-firm proprietors were in favor of including a government-run insurance option in a new national health insurance exchange (Mainstreet Alliance 2009). Given the large potential for gains to small businesses and how constrained their choices are within the ESI status quo, holding up fundamental reform in the name of “protecting” small businesses is questionable at best.

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