Testimony Before the Senate HELP Committee on Health Reform and Small Businesses

Jonathan Gruber, November 2, 2009

The health reform legislation making its way through both Houses of Congress currently will benefit many different groups in society. One of the major winners from this legislation will be small businesses and their employees. Small businesses suffer in our current insurance system from high and unpredictable insurance prices; premiums can rise rapidly with little notice. The reformed system envisioned by Senate and House legislation would provide a more predictable and less expensive environment in which small businesses could purchase quality health insurance. This will promote small business formation and growth by removing this enormous source of uncertainty. Moreover, the legislation would allow small business employees to benefit from the broad range of choices now unavailable to them. In this testimony I will describe in more detail the gains to small businesses and their employees.

Small Business Health Insurance Today

Small businesses and their employees face *four major impediments* in the employment-based system of health insurance in the U.S.

Entrepreneur Deterrence

First, individuals are afraid to start small businesses, or to join new businesses, because of a fear of losing health insurance. Consider the 50 year old engineer at a large firm who has a great idea for a new start-up company, but also has a wife who is a cancer survivor who now benefits from the high quality insurance at that large firm. This engineer may be unwilling to start that new company because of fear of being unable to obtain insurance coverage – or to obtain it only with pre-existing conditions exclusions that would exclude coverage for his wife's cancer. As a result, the engineer will not start the new company, reducing a dynamic source of job growth for the U.S.

Economic studies have confirmed the role of job lock in dissuading entrepreneurship. A number of studies over the past 15 years have shown that those who have access to health insurance outside their employment setting are more likely to start new businesses. For example, one recent study found that not having spousal insurance available, relative to those who do have such insurance, lowers the rate of transition to self-employment by 18-34%.[1] That same study as well as another recent study find that the reduction in the price of insurance for the self-employed led to a significant rise in transitions to self-employment, with the latter study finding that tax subsidies to the self-

[1] Gumus, Gulcin, and Tracy Regan (2009). "Self-Employment and the Role of Health Insurance," Working Paper, University of Miami.

employed raised the probability of entering self-employment by 24% and reduced the rate of exit from self-employment by 16%.[2]

High Loading

The second major impediment faced by small businesses is the much higher loading factors that they must pay on their insurance, leading to higher costs and less purchase of coverage. Data on this point are hard to come by, but the best available data suggest that smallest firms pay as much as 20% more than large firms for the same insurance coverage.[3] These higher loads result from broker commissions (which can run from 4 to 11% of premiums), other fixed costs of administering and selling insurance that raise per person premiums more for smaller firms, and from resources expended by insurance companies in today's environment to try to screen and avoid the sickest firms.

Unpredictable Premiums

The third impediment is the unpredictable nature of those costs, which makes it difficult for small businesses to commit to offering insurance to their employees. For example, one survey found that in 2008, 28% of small firms reported a premium increase of 20% or more.[4] If small firms can anticipate the rate of premium increase, they can account for that in any business growth planning in deciding whether they can afford to offer health insurance. But if they cannot know whether costs will go up by 5% or 30% the next year, they will shy away from providing insurance in the first place.

Limited Choice

Most small firms in the U.S. do not offer their employees a choice of health plans: only 12% of firms with fewer than 200 employees allow their employees 2 plans to choose from, and only 1% of firms in that size range offer three or more choices. In contrast, among firms of over 5000 or more employees, 43% offer 2 choices and another 29% offer three or more choices.[5] This reflects the fact that insurers do not want to insure small firms with segmented risk pools, and the higher administrative costs of small firms that want to offer an array of health plan choices.

How Does Reform Help?

The types of reforms now making their way through Congress would help with all four of these major impediments to small businesses, through several key features:

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[2] Heim, Bradley and Ithai Lurie (2009). "The Effect of Health Insurance Premium Subsidies on Entry Into and Exit from Self-Employment," mimeo, U.S. Department of the Treasury.
[3] Chu, Rose and Gordon Trapnell (2003). "Study of the Administrative Costs and Actuarial Values of Small Health Plans," Small Business Research Summary #224, SBA Office of Advocacy, Washington D.C.
[4] National Small Business Association (2009). "Health Care Survey of Small Businesses".
[5] Data from the Kaiser Family Foundation available at http://ehbs.kff.org/?page=charts&id=2&sn=19&ch=1048

Reformed Insurance Markets with Individual Mandate

Insurance markets will be reformed so that prices depend only on enrollee age and not health, and so that pre-existing conditions cannot be excluded from coverage. This resolves the entrepreneur deterrence effect because the engineer will now be certain that he can get insurance to cover his wife's cancer if necessary, freeing him up to start that new business. This legislation therefore removes an important deterrent to business formation and growth that will increase the productivity of the U.S. workforce.

Insurance market reforms also mitigate the enormous year to year swings in insurance premiums that are so common for small businesses and interfere with their ability to offer insurance. Moreover, the individual mandate ensures that prices in these new exchanges will be low because there will be a mix of both healthy and less healthy enrollees. This will allow insurance companies will be issuing insurance at the same cost, removing the need for screening on health and its associated administrative load.

The Exchange as a Medium of Insurance Purchase

Many of these problems will be addressed further through the ability of small businesses to use the new exchange as a medium for insurance purchase. Small businesses will be able to directly enroll their employees into a marketplace that provides a wide variety of choices over plan design and insurance company. This will substantially mitigate the high loading costs facing small businesses today because they will not be required to use brokers, because they will not face the administrative burdens imposed by focusing on their particular group for insurance sale, and because there will not be resources wasted on health screening. As noted earlier, small businesses pay up to 20% more for insurance today. There is no reason that figure couldn't be cut substantially in an exchange environment.

Moreover, the exchange will provide small business employees with the wide variety of choices that large businesses now provide their employees. This will make it more attractive for small businesses to offer coverage by making it more appealing to their employees. And it will allow small business employees to choose the plan that most appeals to them, rather than being forced into the plan that suits their employer's preferences.

Small Business Tax Credit

Health insurance is expensive in the U.S., and even under these reform bills that will not change right away. As a result, all of the legislative proposals include a sizeable tax credit to help our nation's smallest businesses afford coverage. This credit will offset up to 50% of the premium cost for the smallest and lowest wage businesses that are having the most trouble providing coverage today.

Does Reform Hurt?

Those who argue that reform will hurt small businesses rely on several arguments, all of which are either incorrect or overstated.

Insurance Reform Will Raise Costs

The first claim that is made is that insurance reform will raise costs to small businesses – particularly if there is not a strong mandate in place. In a generic sense, this statement is true – market reform without a mandate can raise premiums. We have seen in a number of states that imposing community rating on the non-group market without a mandate has caused a spike in premiums. But this has not proven to be a major problem to date in the small group market, where state reforms to market rating in the early 1990s did not much increase premiums.[6]

Moreover, there is a very strong mandate in place in legislation proposed by HELP and the House – and a reasonably strong mandate in the SFC legislation as well. This will offset any rate shock from community rating by bringing younger and healthier workers into the risk pool. Finally, the grandfathering provisions in these proposals will protect any small firms that would potentially suffer a rate shock from reform.

Benefit Mandates Will Raise the Cost of Insurance

While the details differ, the legislative proposals before Congress would add a series of requirements to ensure that insurance is providing real protection to consumers. Most notably, they would impose a “minimum actuarial value” that would require coverage at a certain level of benefits by small businesses. Yet the minimum actuarial contemplated by the Senate legislation, which would require that insurance cover 65% of expected medical costs, are not onerous relative to coverage among today’s small businesses. Recent analysis by the Engelberg Center for Health Care Reform at the Brookings Institution finds that fewer than 10% of small firms in the U.S. today offer benefits packages less generous than this level.

The plans would also impose other restrictions on insurance coverage, such as no annual or lifetime limits and mandated preventive care. But once again these are not burdensome mandate for the vast majority of small firms. For those small firms who would have to change their benefits packages to meet the mandate, they can simply adjust other aspects of the package to stay at similar premium level.

Excise taxes and Fees Will Raise Costs

These legislative proposals would impose a set of excise charges on both medical providers and the insurance industry. The final form of these excise charges is currently under debate. But to the extent they follow the form of the Senate Finance Committee

[6] Simon, Kosali (2005). “Adverse Selection in Health Insurance Markets? Evidence from State Small Group Health Insurance Reforms,” *Journal of Public Economics*, 89, 1865-1877.

proposal evaluated by CBO on September 22nd, they will have a trivial effect on premiums; CBO reports that the excise fees will add up to less than 1% of insurance premiums.[7]

Employer Responsibility Requirements will Hurt Small Business

The legislation being considered would include some financial consequences for businesses that do not offer insurance coverage. But these assessments would not hit the smallest businesses. The free rider assessment in the Senate Finance Committee bill, for example, would apply only to firms above 50 employees. Even past that point, the requirement would be quite modest, at most $400 per full time employee. This is only about a 1% rise in the cost of compensation.

Objective Evidence that Reform Will Lower Premiums

Reports sponsored by the insurance industry have argued that reform will lead to higher premiums for small firms.[8] Unfortunately, I am aware of no objective party which has presented an analysis of the impact of reform on small business premiums. But there is some guidance as to the validity of existing analyses from CBO analysis of the impact of reform on the non-group market. The same reports that claim that reform will dramatically increase small group premiums have made the claim even more strongly with respect to non-group premiums, with estimated increases from reform of 50% or more. But the objective CBO analysis shows that these claims are clearly wrong – reform will *lower*, not increase, non-group insurance costs.

In their September 22nd letter, the Congressional Budget Office reported that they estimated the cost of an individual low-cost "silver" plan in the exchange to be $4700 in 2016 (this was later updated to $5000). This is a plan with an "actuarial value" (roughly, the share of expenses for a given population covered by insurance) of 70%. In the same letter, the CBO projected that, absent reform, the cost of an individual policy in the non-group market would be $6000 for a plan with an actuarial value of 60%. This implies that the same plan that cost $6000 without reform would cost $4300 with reform, or *almost 30% less*.

The CBO has not reported many of the details of their analysis, such as the age distribution of individuals in the non-group market or in the exchange. So these data do not provide a strictly apples to apples comparison of premiums for the same individual in the exchange and in the no-reform non-group market. Moreover, CBO's conclusion may change as legislation moves forward. But the key point is that, as of now, the most authoritative objective voice in this debate suggests that reform will significantly reduce, not increase, non-group premiums. This is in stark contrast to the critical reports from

[7] Letter from CBO Director Douglas Elmendorf to Senate Finance Committee Chairman Max Baucus on September 22nd, 2009.
[8] Oliver Wyman, "Insurance Reforms Must Include a Strong Individual Mandate and Other Key Provisions to Ensure Affordability"; PriceWaterhouseCoopers, "Potential Impact of Health Reform on the Cost of Private Health Insurance Coverage".

the insurance industry – and suggests a potential bias to their conclusions for small firms as well.

The Prospects for Small Businesses With and Without Reform: Modeling Results

I recently provided background research for a study by the Small Business Majority of the impacts of reform options on small businesses.[9] I have undertaken similar calculations for this testimony for the Senate Finance legislation. These results draw on the Gruber Microsimulation Model (GMSIM), which has been widely used for policy analysis at both the state and federal level. This model parallels the type of model used by the Congressional Budget Office in their analyses of health reform proposals.

I have used this model to project two scenarios for small businesses (with fewer than 100 employees): no reform (the "status quo") and the Senate Finance Legislation ("reform"). I conservatively assume that in both scenarios the underlying premium growth rate for small businesses will be 6%/year, which is below the recent trends, and which gives no credit to the reform for lowering the rate of health insurance cost growth. I do assume that reform lowers costs to small businesses by 5% on average through the set of policies I described above.

My modeling results show an enormous reduction in small business spending through health care reform. I estimate that in 2019, absent reform, small businesses will spend roughly $290 billion/year in health insurance premiums. Under reform, I see that number falling by about 25% to $225 billion/year.

This lower spending has real consequences for small businesses and their workers. I estimate that under reform workers in small businesses will see an increase in their take-home pay of almost $30 billion/year, and that reform would save about 80,000 jobs in the small business sector by 2019.

These are only estimates based on a highly uncertain future. But the assumptions about cost growth in the small business sector are conservative so the gains could be even larger.

Conclusion

As this testimony makes clear, small business has little to fear, and much to gain, from health reform. A reformed insurance market with efficient exchanges will offer both lower health insurance costs and more premium stability for small firms. And employees will be free to move from job to job and start new small businesses, as well as to benefit from a much greater choice of health care plans in the small businesses in which they work.

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[9] Small Business Majority (2009). "The Economic Impact of Health Reform on Small Businesses," June 11, 2009.