Executive Summary
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Reducing Uninsurance by Reforming Health Insurance in the Small-Business Sector

Stuart M. Butler, Ph.D.

Uninsurance is overwhelmingly a problem of the small-business sector. Almost half of America's uninsured workers are either self-employed or in firms with fewer than 25 workers. Moreover, the rate of uninsurance is highest among such workers and their families. Over 30 percent of workers in small firms lack insurance.

This high level of uninsurance underscores the inherent limitation of traditional employer-sponsored insurance for workers in small firms. While it usually does make sense for large, sophisticated employers to sponsor insurance—in other words, to arrange coverage—it is administratively costly and inefficient for small employers to try to sponsor health plans. Small firms also can rarely offer plan choices to their employees and tailor coverage to worker needs, and owners of small firms are more reluctant to undertake the hassle of organizing insurance. Subsidizing these small employers would not overcome these drawbacks.

Addressing Uninsurance in the Small-Business Sector. What is needed is a variant of employment-based coverage for certain groups of workers, especially employees of small firms. Such a variant should enshrine three key goals:

- Financial assistance to families for health insurance coverage should be based on need.
- The available choices of health insurance should not depend on the place of employment.
- While workers would continue to sign up for coverage in the workplace and obtain tax subsidies through the workplace, employers should not necessarily sponsor health insurance.

Increasing Coverage for the Employees of Small Firms. Crafting such a variant of employer-based insurance for workers in small firms requires lawmakers to take the following steps:

1. **Create a refundable tax credit for workers in small firms in order to eliminate the bias against employees choosing their own coverage and to subsidize those who need the most help.** Today, the tax treatment of health insurance favors those with higher incomes and requires workers to hand over control of their coverage to their employers. A refundable health credit would give the most help to those in need and would enable these workers and their families to obtain insurance outside the workplace if that makes more sense.
2. **Create alternative pools for the employees of small firms—including plans offered through churches, unions, and other intermediaries—so that these workers and their**

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families can access a wide range of affordable plans. Making it easier for workers to obtain coverage through groups other than employer-sponsored organizations would enable many families to pick plans offered through large organizations, including those where they already have a membership, such as unions and churches. In addition, Congress needs to take steps to structure a reinsurance market to manage and spread the insurance risk among such groups. This would make it easier for workers in small firms to obtain affordable insurance through organizations they trust.

3. **Make it easier for employees to sign up for insurance in the workplace—even when the employer does not sponsor insurance—by removing tax and regulatory obstacles.** Rather than sponsoring insurance themselves, it would make more sense for many small employers to make it easy for their employees to enroll in plans available in the area through payroll deductions, automatic enrollment, adjusting tax withholdings to reflect available tax credits, and facilitating payments. Many employers would also prefer to make a cash payment toward the cost of coverage rather than organizing that coverage. Federal tax and insurance rules need to be clarified to make this easier for small employers.

Conclusion. The high rates of uninsurance among working families in small firms are a testament to the limitations of the employment-based health system in the small-business sector. Yet the tax system and government insurance rules discourage other insurance arrangements for these uninsured working families.

Proposals for individual tax credits for health coverage would help to remove this barrier to alternative insurance arrangements. In addition, taking steps to build an insurance infrastructure with affordable choices would enable these families to have coverage that is similar to—or even better than—the insurance available to employees of large firms.

With these reforms in place, new forms of coverage would become available to working Americans in the small-business sector. For this to occur, however, Congress must recognize that an important distinction exists between using the place of employment as the convenient place to obtain insurance and making tax relief to families contingent upon employer sponsorship of their health insurance.

—Stuart M. Butler, Ph.D., is Vice President for Domestic and Economic Policy Studies at The Heritage Foundation.

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Stuart M. Butler, Ph.D.

Families lacking health insurance is a persistent problem in the United States. According to projections based on a sampling for the Kaiser Family Foundation, approximately 43 million non-elderly Americans were uninsured at any point during 2002.[1] According to the Congressional Budget Office, based on survey figures for 1998, between 21 million and 31 million people lacked insurance for the entire year, while nearly 60 million were uninsured at some point during the year.[2]

For some of these people, a short spell without insurance poses no real hardship. Some are "voluntarily" uninsured, in that they consciously decide to forgo insurance that they can afford and take the financial risk. Many of these individuals pay directly for routine care and/or use the emergency room. But millions of others desire insurance, yet cannot afford it or otherwise obtain adequate coverage. For these Americans, a major illness or accident could mean financial ruin or going without necessary care.

According to the Kaiser survey, about two-thirds of the non-elderly uninsured are from low-income families (less than 200 percent of the poverty level, or approximately $29,000 for a family of three). Moreover, about 80 percent (including children) come from working families, and 70 percent have a family member working full-time.[3]

Small-Business Insurance Is Dysfunctional

While most uninsured people are in working families, they are not spread evenly across the workplace. Instead, they are heavily concentrated in the

Talking Points

- Uninsurance is overwhelmingly a small-business problem. Almost half of all the uninsured workers are either self-employed or in firms with fewer than 25 workers. Over 30 percent of workers in small firms lack insurance.
- Small firms are poor locations for sponsoring insurance. Many small-business owners want to avoid the hassle of organizing insurance. Even if they offer coverage, they are small and unstable insurance pools and thus face high administrative costs and generally lower benefits, and they can rarely offer a choice of plans.
- To solve this problem, Congress needs to take three steps. It should enact refundable tax credits to enable these workers to afford coverage outside the workplace; create alternative pools for these workers, modeled on Congress's own FEHBP; and make it easier for small firms to facilitate insurance for workers rather than sponsor plans.

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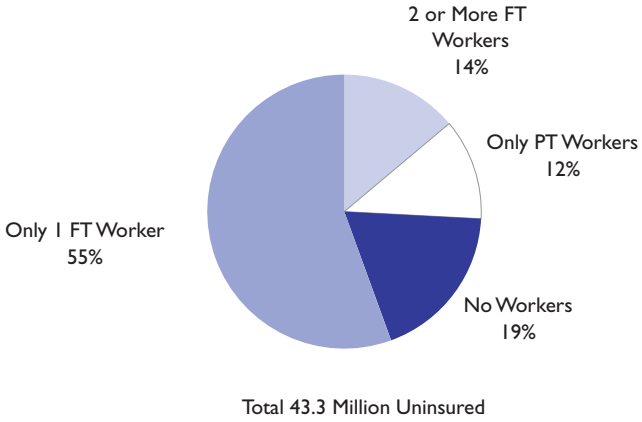
small-business sector. The Kaiser survey[4] indicates that:

- Almost half (48.7 percent) of all uninsured workers are either self-employed or work for firms with fewer than 25 workers.
- The highest rates of uninsurance are also among these workers. Some 26.3 percent of self-employed workers are uninsured, as are nearly one-third (31.2 percent) of all workers in firms with fewer than 25 employees. Analysis by the Employee Benefit Research Institute underscores this general pattern: the smaller the firm, the higher the probability that workers will be uninsured.[5]
- Meanwhile, just 12.6 percent of workers in firms with 1,000 or more employees lack insurance—typically low-paid individuals who decline offered coverage.

Chart 1 B 1769

Uninsured Mainly in Working Families: Non-elderly Uninsured by Family Work Status, 2002



Total 43.3 Million Uninsured

Note: FT=Full-Time; PT=Part-Time.

Source: Figure 9 in Catherine Hoffman and Marie Wang, *Health Insurance in America: 2002 Data Update*, The Kaiser Commission on Medicaid and the Uninsured, December 2003, p. 10. Used with permission.

The concentration of uninsurance in small-business and lower-income households helps to explain the high level of uninsurance among non-managers in such occupations as agriculture (42.7 percent of non-managers uninsured), construction (37.8 percent), and services (34.6 percent), where small firms and lower-income households are disproportionately represented.

- The preponderance of minorities in small firms also helps to explain the high levels of uninsurance among Hispanic workers (38.7 percent) and black Americans (23.7 percent), compared with relatively low rates among whites (13.2 percent).[6]

Thus, while uninsurance occurs in every stratum of American society, even among highly paid households, it is heavily concentrated in households in the small-business sector.

- Less than 30 percent of low-income, full-time workers in firms with fewer than 25 employees have insurance.[7]

1. Kaiser Commission on Medicaid and the Uninsured, *Health Insurance Coverage in America: 2002 Data Update* (Washington, D.C.: Kaiser Family Foundation, 2003), p. 6.
2. Douglas Holtz-Eakin, "The Uninsured and Rising Health Insurance Premiums," Congressional Budget Office testimony before the Subcommittee on Health, Committee on Ways and Means, U.S. House of Representatives, March 9, 2004. See also Congressional Budget Office, *How Many People Lack Health Insurance and for How Long*, 2003.
3. Kaiser Commission, *Health Insurance Coverage*, pp. 9 and 10.
4. *Ibid.*, pp. 19 and 34.
5. "Sources of Health Insurance and the Characteristics of the Uninsured: Analysis of the March 2003 Current Population Survey," Employee Benefit Research Institute *Issue Brief* No. 264, December 2003.
6. Kaiser Commission, *Health Insurance Coverage*, pp. 19 and 34.
7. *Ibid.*, p. 19.

There are certainly weaknesses in using the large-business sector to provide insurance, but it does function as a workable system; however, for close to a majority of workers in small firms, the system of health insurance in the small-business sector is practically dysfunctional.

To address the inherent weakness of employer-sponsored coverage in the small-business sector, policymakers should not try to force or induce small employers to act like large-firm sponsors of insurance. That will never be effective. Instead, they should empower employees of small firms to make the same choices as employees of large firms while enabling small employers to facilitate those choices. Specifically, Congress should:

- **Create** a refundable tax credit for workers in small firms in order to eliminate the bias against employees choosing their own coverage and to subsidize those who need the most help.
- **Create** alternative pools for employees of small firms—including plans offered through churches, unions, and other intermediaries—so that these workers and their families can access a wide range of affordable plans.
- **Make it easier** for employees of small firms to sign up for insurance at the workplace—even when the employer does not sponsor insurance—by removing tax and regulatory obstacles.

Why Small-Business–Based Insurance Is in Deep Trouble

Surveys indicate that working Americans generally prefer employer-based health coverage to other ways of acquiring health insurance, and many experts maintain that employment-based coverage has many advantages.[8] However, most of the generic advantages of employment-based insurance apply far less, or not at all, to the self-employed and to workers in small firms.[9]

There are several reasons for the general popularity of employer-sponsored coverage and several reasons why small firms are the exception.

- **Employment-based coverage is the only way for most families to obtain a very large tax benefit for insurance costs.** This tax benefit is smaller and less available for workers in small firms. When part of a worker's compensation is provided in the form of health insurance, the value of that compensation is exempt from all income taxes (state as well as federal) and all payroll taxes (i.e., Social Security and Medicare taxes). The total value of this "tax exclusion" in 2004 is projected by analysts at the Lewin Group to be about $188.5 billion in federal and state income and payroll taxes.[10]

  But there are two snags with this form of tax subsidy:

  It favors high-income households over low-income households. For an insured family with an annual income over $100,000, the average value of the tax benefit in 2004 is estimated by Lewin Group analysts at $2,780. For lower-income but insured families, the tax benefit is a small fraction of that amount because their marginal tax rate is lower. Families with household incomes of from $20,000–$30,000 receive a tax benefit averaging just $725.[11]

  If the employer does not offer insurance (or affordable insurance) for a particular worker, the family

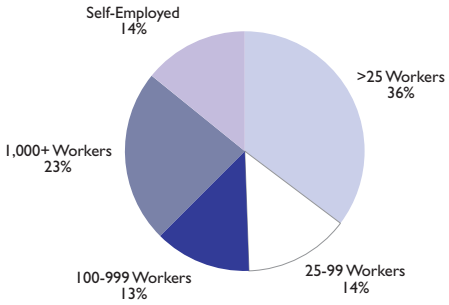
8. For a summary of the advantages of employer-sponsored coverage, see William S. Custer, Charles N. Kahn III, and Thomas F. Wildsmith IV, "Why We Should Keep the Employment-Based Health Insurance System," *Health Affairs*, Vol. 18, No. 6 (November/December 1999), pp. 115–122.
9. For a summary of the pros and cons of employer-sponsored coverage, see Uwe E. Reinhardt, "Employer-Based Insurance: A Balance Sheet," *Health Affairs*, Vol. 18, No. 6 (November/December 1999), pp. 124–132.
10. John Sheils and Randall Haught, "The Cost of Tax-Exempt Health Benefits in 2004," Web exclusive, *Health Affairs*, February 25, 2004, at *content.healthaffairs.org/cgi/reprint/hlthaff.w4.106v1.pdf*.
11. This figure averages workers with and without insurance, so the tax subsidy for an insured lower-income worker would be higher than this. Nonetheless, a worker in the lowest federal tax bracket would receive only just over half the subsidy for insurance received by an upper-income worker.

Charts 2-4 B 1769

Uninsured Concentrated in Small Firms

Chart 2

Uninsured Workers by Business Size, 2002



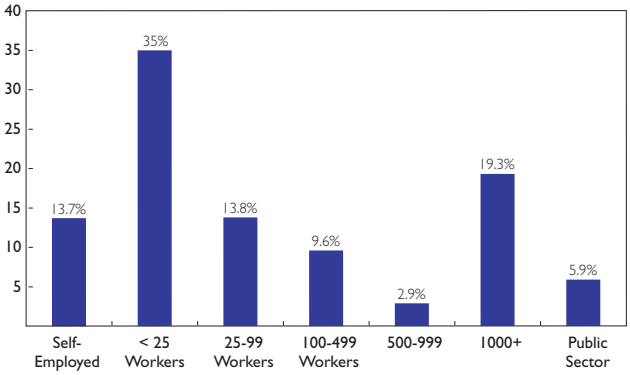
Total = 25.7 Million Uninsured Workers

Note: Data do not total 100% due to rounding.

Source: Figure 25 in Catherine Hoffman and Marie Wang, *Health Insurance in America: 2002 Data Update*, The Kaiser Commission on Medicaid and the Uninsured, December 2003, p. 18. Used with permission.

Chart 3

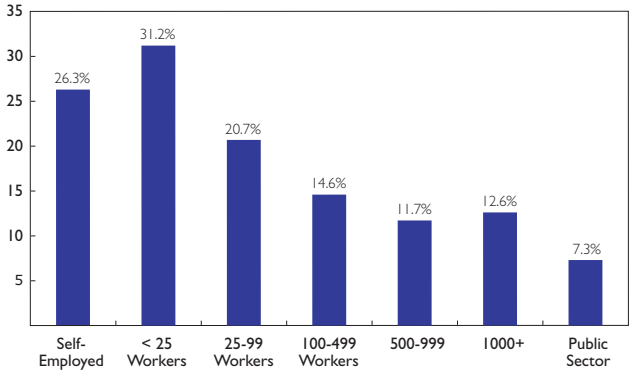
Percentage of Uninsured Workers by Firm Size, 2002



Source: Data from Table 12 in Catherine Hoffman and Marie Wang, *Health Insurance in America: 2002 Data Update*, The Kaiser Commission on Medicaid and the Uninsured, December 2003, p. 34. Used with permission.

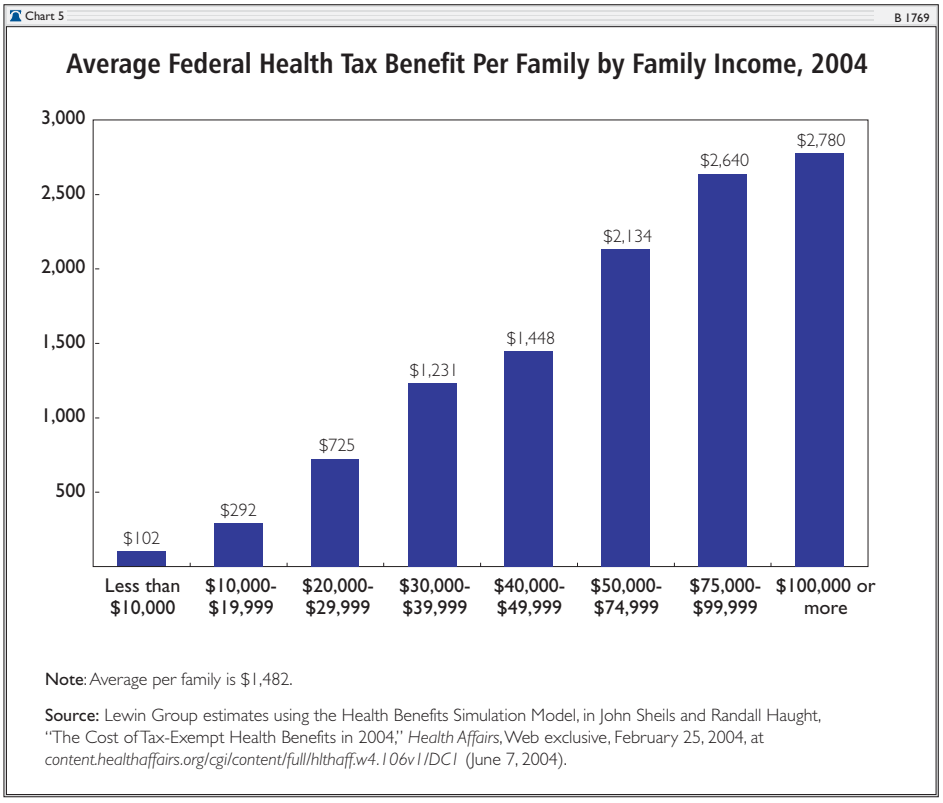
Chart 4

Rate of Uninsurance Among Workers by Firm Size, 2002



Source: Data from Table 12 in Catherine Hoffman and Marie Wang, *Health Insurance in America: 2002 Data Update*, The Kaiser Commission on Medicaid and the Uninsured, December 2003, p. 34. Used with permission.

typically does not receive a tax break or other subsidy to help purchase insurance. If the employer does not offer insurance, or if the worker cannot afford to enroll in the available plan, there is of course no tax subsidy. But if such an uninsured person considers buying coverage for himself and his family, he normally receives no tax benefits at all. The whole cost is in after-tax income.



A small firm is far less likely to offer insurance, which means employees of such a firm would receive no tax break, and lower-income workers are more commonly employed in smaller firms. According to a recent survey by the Kaiser Family Foundation, while 98 percent of firms with at least 200 employees offered insurance in 2003, only 65 percent of firms with fewer than 200 offered insurance. Not surprisingly, in 2001, some 64 percent of uninsured workers were not even offered insurance through their own job.[12] According to a survey of firms in 1999, only 55 percent of firms with fewer than 10 employees offered insurance.[13]

- **Employment-based insurance is very convenient—if it is available.** The workplace is a convenient location for many transactions. For instance, most Americans pay their income tax through withholding available at their workplace. Many employees also contribute to their own IRA-type pension savings plan—typically a 401(k) plan—by having their employer make a deduction from their paychecks.

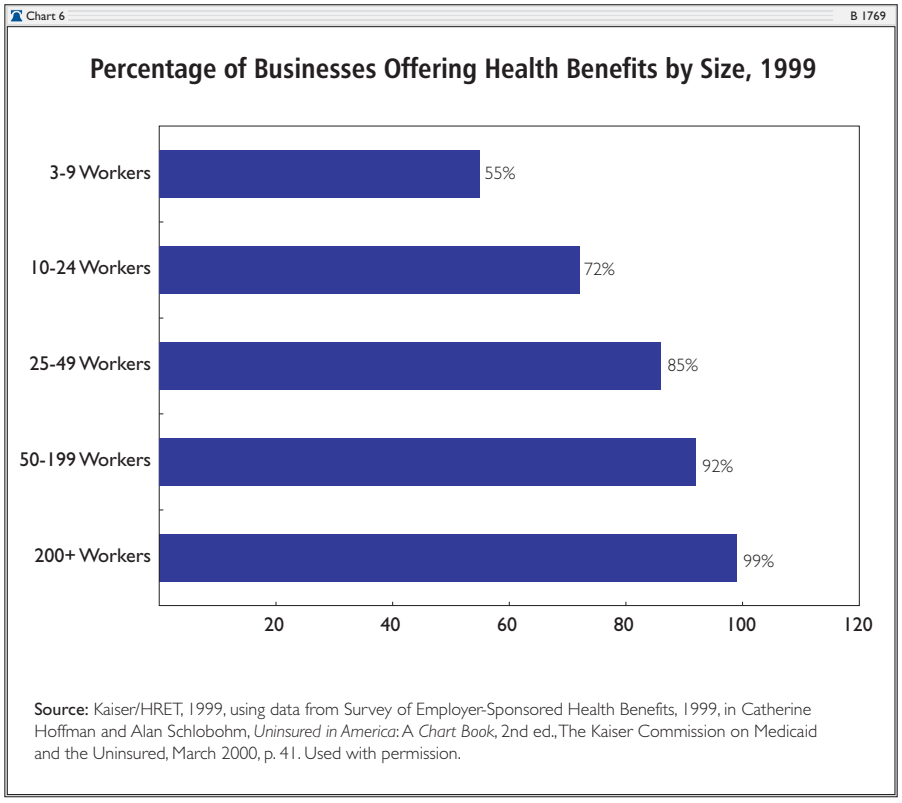
  Similarly, when an employer provides health coverage, an employee can easily participate in the plan, assuming the worker can afford it. Premiums are paid directly by the employer, and the worker does not even have to apply for a tax exclusion. The W-2 form, which indicates the worker's income for tax purposes, simply makes no mention of the employer's contribution to the worker's health insurance. Moreover, if the worker has to pay something toward the cost of the plan, this is usually done through a convenient payroll deduction during each pay period.

  This "automatic" way of obtaining health insurance works well for larger firms; but because smaller employers are far less likely to

12. Kaiser Commission on Medicaid and the Uninsured, *The Uninsured: A Primer* (Washington, D.C.: Kaiser Family Foundation, 2003), p. 13, at *www.kff.org/uninsured/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=29345*.
13. Kaiser Commission on Medicaid and the Uninsured, *Uninsured in America: A Chart Book* (Washington, D.C.: Kaiser Family Foundation, 2000), p. 41, at *www.kff.org/uninsured/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=14629*.

offer insurance, they are also far less likely to set up a payroll deduction system for employees who wish to arrange their own coverage.

- **Large firms provide a large and stable insurance pooling. Small firms do not.** A company with a large work force obviously also has a large pool for insurance purposes. This means that the insurance risk for healthier and sicker employees can be spread across the large group and that the insurer (sometimes the firm itself, functioning as a "self-insurer") can predict average usage more accurately. Thus, an insurer can estimate the expected total claims cost for the group fairly accurately.

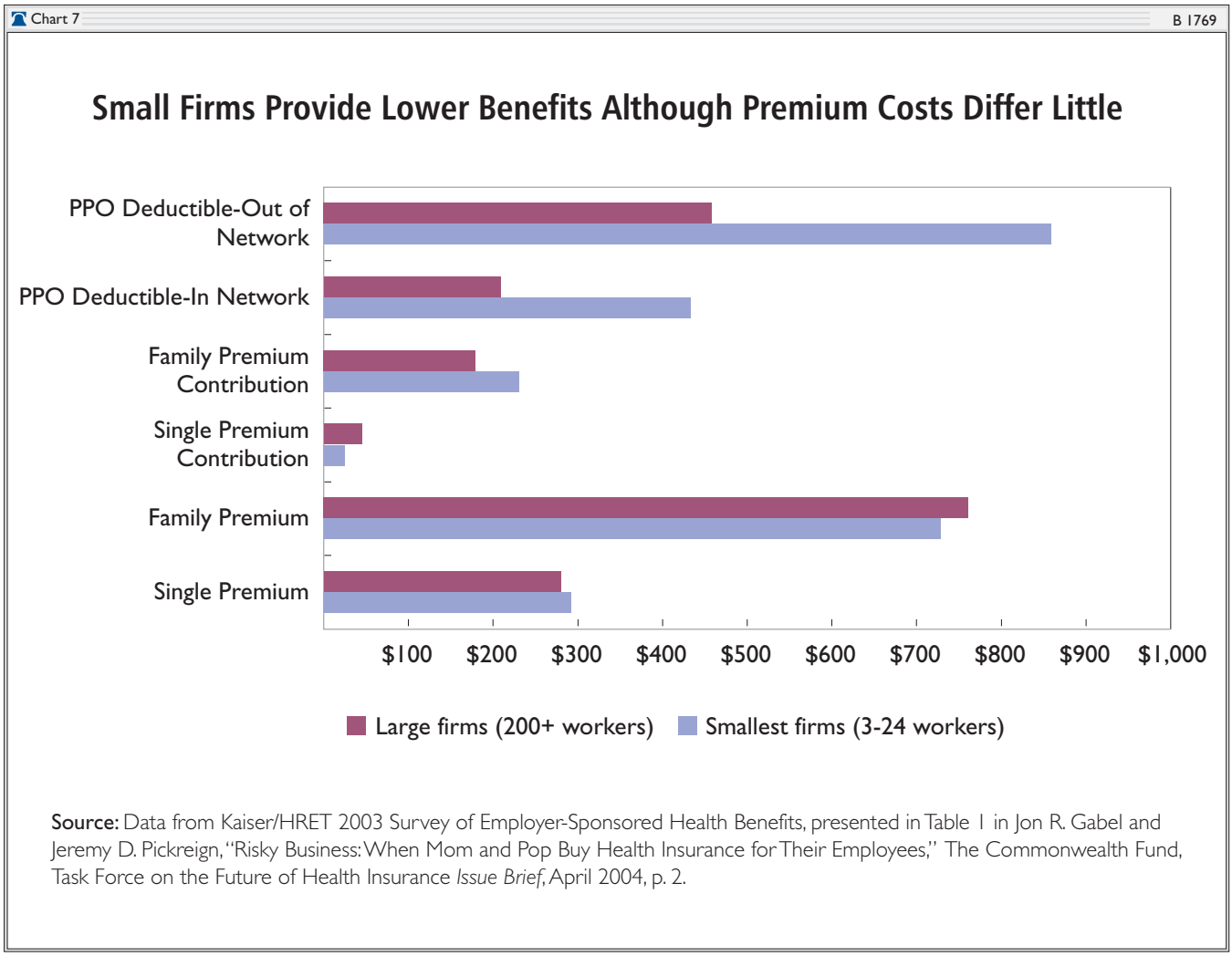


Source: Kaiser/HRET, 1999, using data from Survey of Employer-Sponsored Health Benefits, 1999, in Catherine Hoffman and Alan Schlobohm, *Uninsured in America: A Chart Book*, 2nd ed., The Kaiser Commission on Medicaid and the Uninsured, March 2000, p. 41. Used with permission.

Moreover, if a new employee poses particularly high—or low—insurance risk (and therefore incurs particularly higher or lower medical expenses), this will not significantly change the group's expected total cost, and an insurer can offer a group premium that will not change drastically over time (other than tracking the general growth rate for medical expenditures), despite possibly wide variations in medical risks among employees. Large companies also have the economies of scale and sophistication to provide insurance at a low administrative cost per employee.

Small firms, however, are by definition small insurance pools. A retail store with a handful of employees is a dismal pool for insurance purposes. Hiring a new employee with a disability, or the diagnosis of a chronic heart problem in an older worker, can dramatically change insurance costs for the employer from one year to the next. States and the federal government recognize this and are exploring various ways to group small firms together to form larger insurance pools. But the need for these efforts only underscores the fact that small firms are a poor basis for pooling employees' insurance risks.

Three criteria for risk pools. It is also important to recognize that the size of a risk pool is only one of three important criteria for a good insurance risk pool. The other two are randomness and stability, which also present problems for small employers and even groups of small employers. In other words, the group must be in line with the health risk associated with a random cross section of the population from which the employees are typically drawn, and the group's composition must not change frequently. Unfortunately, the employee turnover rate in small business is relatively high, as is the tendency of firm-owners to withdraw from multi-employer groups if they can obtain less expensive coverage somewhere else.



Source: Data from Kaiser/HRET 2003 Survey of Employer-Sponsored Health Benefits, presented in Table 1 in Jon R. Gabel and Jeremy D. Pickreign, "Risky Business: When Mom and Pop Buy Health Insurance for Their Employees," The Commonwealth Fund, Task Force on the Future of Health Insurance *Issue Brief*, April 2004, p. 2.

- **Advantages in bargaining and administration depend on firm size.** Larger firms can bargain quite effectively with insurers and providers and thus are able to deliver cost-effective coverage that is often tailored specifically for their work force. Moreover, because they have a large group available to the insurer (or the plan administrator if they are self-insured), administrative costs per worker tend to be relatively low.

  Again, this advantage does not exist with small firms. Small firms face relatively high administrative costs, and many small-business owners consequently do not see it as efficient to organize insurance. Precisely because they lack the economies of scale and the management resources of larger firms, small businesses tend to face high costs when administering plans. According to data collected by the Congressional Budget Office, overhead costs for providing insurance can be over 30 percent of premium costs for firms with fewer than 10 employees, compared with about 12 percent for firms with more than 500 employees.[14]

  In addition to simple economies of scale, other things such as higher staff turnover contribute to this difference. Moreover, many small-business owners have little desire to engage in the demanding task of organizing health insurance

14. Congressional Budget Office, *The Tax Treatment of Employment-Based Health Insurance*, 1994, p. 8.

to meet the often-varied needs of their employees.

- **The degree of choice is related to the size of the employer.** Because of the size of their insurance pools and their sophistication, large companies can more easily provide a choice of health plans, making it more likely that their workers will be reasonably satisfied with their coverage. Small firms, however, can rarely offer a choice of plans. If a small employer provides coverage, it tends to be a single "one-size-fits-all" plan. While 61 percent of workers with insurance in firms of 5,000 or more employees had a choice of at least three plans in 2003, only 20 percent of covered workers in companies with fewer than 100 employees had a similar choice of at least three plans.[15]
- **Small firms cannot provide the same quality of benefits.** Even if a small employer decides to offer a plan, that employer typically cannot offer the same quality of benefits as a larger employer. High administrative costs, low bargaining clout, small and unstable pools, and the other obstacles combine to reduce the quality of benefits that can be offered.

  A recent study by Jon Gabel and Jeremy Pickreign for the Commonwealth Fund underscores this disadvantage. The study used 2002–2003 survey data from the Kaiser Family Foundation and other sources and found that, although premiums charged to firms were comparable between firms of different sizes, the premiums bought fewer benefits for the workers and their families in small firms.[16]

  For example, only 38 percent of workers in firms with fewer than 25 employees were offered dental benefits, compared with 87 percent in firms of 200 or more. Meanwhile, 100 percent of employees in the large firms had access to prenatal care benefits, compared with 93 percent in the smaller firms. Moreover, employees of the small firms faced far higher deductibles for single or family coverage.

Goals for Addressing Uninsurance in the Small-Business Sector

With such a heavy concentration of the uninsured employed and their dependents in the small-business sector, it makes sense to focus efforts on addressing the obstacles facing families in that sector.

A good way to approach the task is first to consider the overarching goals that one would want to achieve, not just for these families, but also in the long term for all Americans.

Goal #1: Financial assistance to families for health insurance coverage should be based on need.

As noted earlier, many lower-paid employees in small firms face a subsidy double-whammy. Those who are offered insurance are paid less and thus get a much smaller tax benefit than upper-income employees through the exclusion from taxable income of employer-sponsored health benefits. Many have no employer-sponsored insurance at all, and if they purchase their own insurance, they typically receive no tax break.

A sensible reform would be to provide similar tax breaks or other assistance to families whether or not they obtained their insurance through the workplace. Rather than a tax exclusion or a tax decision, which gives the most help to those with the highest income, a more efficient and fairer approach would concentrate more help on lower-paid Americans, perhaps through a tax credit.

Goal #2: The available choices of health insurance should not depend on the place of employment.

15. Kaiser Family Foundation/Health Research and Educational Trust, *Employer Health Benefits*, 2003 (Washington, D.C.: Kaiser Family Foundation, 2004), at *www.kff.org/insurance/ehbs2003-6-set.cfm.* See also "Exhibit 2.6: Percentage of Employers Providing a Choice of Health Plans, by Firm Size, 2003," in *Trends and Indicators in the Changing Health Care Marketplace, 2004 Update*, Kaiser Family Foundation, April 2004, at *www.kff.org/insurance/7031/ti2004-2-6.cfm*.

16. Jon R. Gabel and Jeremy D. Pickreign, "Risky Business: When Mom and Pop Buy Health Insurance for Their Employees," Commonwealth Fund *Issue Brief*, April 2004, at *www.cmwf.org/programs/insurance/gabel_riskybusiness_ib_722.pdf*.

Unlike the employees of large firms, workers in small business currently have little or no choice of coverage, even if they are offered tax-advantaged insurance.

A sensible reform would be to permit workers in small firms to use any tax break or other subsidy available to them to purchase a plan of their own choice, not just the one (if any) selected by their employer. This reform would allow workers in small firms to obtain insurance through large pools or organizations equivalent in size and sophistication to large employers. It would also mean that employees could retain their chosen coverage if they changed employers.

Goal #3: While workers would continue to sign up for coverage in the workplace and obtain tax subsidies through the workplace, employers should not have to sponsor health insurance for workers in order to be eligible for tax subsidies.

Changing the nature of today's tax subsidy and widening the choice of insurance plans for workers in small firms means rethinking the role of small employers in the provision of health insurance. Large firms typically both *sponsor* insurance (i.e., select the plans or self-insure) and *facilitate* insurance (i.e., arrange for employees to sign up and pay for insurance).

Given the obstacles that make it very uneconomic for small firms to offer coverage, divorcing the sponsor and facilitator roles—and leaving smaller firms with only the facilitator role—would reduce the burden and risk for many small employers and make it more likely that they would help their employees to select and sign up for coverage.

Three Steps to Increase Coverage for the Employees of Small Firms

The inherent weaknesses of small firms as sponsors of health insurance require policymakers to think differently about the role of small employers. Thinking of them as just small versions of large firms overlooks the different nature of the small-business workplace.

Instead, policymakers need to construct a health insurance infrastructure for workers in the small-business sector that achieves—or exceeds—the insurance advantages of large firms by altering the role of the small employer and changing how benefits are subsidized. (For an overview of the proposed changes, see Figure 1 and Figure 2 in the Appendix.) Congress needs to take three steps to do this:

Step #1: Create a refundable tax credit for workers in small firms in order to eliminate the bias against employees choosing their own coverage and to subsidize those who need the most help.

Unlike a tax deduction or tax exclusion, which favors upper-income workers, a tax credit provides either the same level of assistance to each recipient or even more help for lower-paid individuals. It can be designed in various ways. A credit can be in the form of a fixed dollar credit; a percentage of the premium and/or out-of-pocket, perhaps with a maximum credit amount; or a combination—a base fixed amount plus a percentage of the premium. Each has different effects and financial consequences.[17]

Making a credit refundable means that if the available credit exceeds the tax liability of an individual or family, the government would remit the difference. Hence, a refundable credit is in effect a health insurance voucher available through the tax system.

A refundable credit could be limited to workers who are not offered a plan by their employer. A criticism of this approach is that it might induce some small employers now offering insurance to end their plans in favor of allowing their employees to qualify for a credit. While, in most cases, this would actually make the employee better off, it remains a widely held criticism. On the other hand, giving the same tax credit to all workers in small firms—whether or not they are offered employer-sponsored coverage—means that workers with employer-sponsored coverage would

17. Stuart M. Butler, Ph.D., "Time for Bipartisan Action to Help Families Without Health Insurance," Heritage Foundation *Backgrounder* No. 1528, March 20, 2002, at *www.heritage.org/Research/HealthCare/BG1528.cfm.*

Why a Subsidy for Small Employers Is Not the Answer

With small employers facing higher costs for the same quality of insurance and many disinclined to offer insurance at all, some policymakers argue that a subsidy to small employers is needed to boost the rate of coverage and thus reduce uninsurance. Typically, such policymakers propose a tax credit to employers to offset part of the cost of insurance. However:

- A subsidy would not make small employers more efficient or sophisticated in bargaining for health benefits; nor would a subsidy deal with the "hassle factor" that causes so many small-business owners to compete for workers by giving cash instead of complex benefits.
- Tax credits for employers—in contrast to tax credits for employees—are difficult to target efficiently. If the government wishes to help lower-income families to afford insurance, it can use eligibility criteria based on family income, but if it tries to do this through a credit for employers, there is the problem of ensuring that the subsidy supports coverage only for those who really need assistance. Simply providing a subsidy to all small businesses would not do this, since the taxpayer would end up subsidizing the coverage of many well-paid lawyers, doctors, computer engineers, and others who work for small firms.

Trying to limit subsidies to the cost of covering lower-income households would require employers to determine the household income of their employees, which would be a burden and would also raise issues of privacy and potential fraud. Indeed, the financial incentive for both employer and worker to understate household income in order to establish eligibility would invite fraud and therefore would require careful audits by the government. If such an audit discovered that an employer had claimed a credit inappropriately, it would be difficult to know whether the employer had committed fraud or had simply been supplied erroneous income information by the worker. This legal jeopardy would discourage many employers from claiming the credit.

enjoy "double-dip" tax relief in the form of the tax credit and the exclusion for their employer-directed compensation.

To avoid either situation, a "full" tax credit could be given to workers who are without sponsored insurance and a smaller tax credit to those who have a sponsored plan; the amount of the latter credit, when combined with the tax value of the exclusion, would be designed to be approximately equal to the full credit. In this way, the tax credit would not be biased either for or against an employer-sponsored plan.

Delivering the Credit Through the Withholding System. The simplest way to deliver the subsidy to workers would be through an adjustment in tax withholdings, much as deductions (such as mortgage interest) or credits (such as the child care credit) are typically handled today with the employer remitting tax payments to the government that are net of the credits. This means that workers would receive the tax benefit in increments throughout the year when they receive their paychecks.

Employers could also institute a system of payroll deductions for health premiums, perhaps through the existing rules for flexible benefit plans, so that the money would be available when premiums were due. Employers could pay premiums directly from these accounts on behalf of employees. In this way, the credit-premium transaction would be relatively simple for both employer and employee.

An Alternative: Assigning the Credit to a Health Plan. Another option would be to permit families to assign the value of their credit to their insurance plan in return for a lower premium.

With the assignment, the employee signs a document allowing the insurer to claim the credit on his behalf and the insurer agrees to reduce premiums by the same amount. Insurers would normally obtain the credit through an adjustment in their tax payments to the government. Thus, rather than deal with the withholding system, a family would only have to establish its eligibility for a fixed or simple percentage credit.

This alternative would be particularly attractive to those lower-income families that do not even file tax returns and would address the concern that the tax subsidy might not be available when premiums are due. The process would mirror the premium payment system in the Federal Employees Health Benefits Program (FEHBP), under which Members of Congress and other federal employees are quoted premiums net of the government contribution.

Boosting Coverage Through Automatic Enrollment. Whether or not they sponsored insurance, employers could institute an automatic enrollment and payment system to make health insurance premium payments and obtain health-related tax benefits. This means that employees would automatically be enrolled in a health plan unless they explicitly declined to enroll, perhaps by signing a document indicating that they understood the possible consequences of not enrolling in a plan. Alternatively, a state could establish a default bare-bones health plan in conjunction with a private insurer, to which anyone not otherwise choosing a plan would be assigned.

Evidence from pension plans indicates that an automatic enrollment system for health insurance could sharply increase sign-up rates.[18]

Tax Credit Proposals in Congress. Several recently introduced legislative proposals are based on the health care tax credit concept. With some variation, the proposals focus primarily on providing tax credits to lower-income individuals and families without coverage.

These proposals have also garnered bipartisan and even tripartisan support. For example, Senator Rick Santorum (R–PA) and Representatives Mark Kennedy (R–WI) and William Lipinski (D–IL) introduced similar legislation in the Fair Care for the Uninsured Act (S. 1570 and H.R. 583). Representatives Kay Granger (R–TX) and Albert Wynn (D–MD) introduced the Securing Access, Value, and Equality (SAVE) in Health Care Act (H.R. 1236). In 2001, Senator James Jeffords (I–VT) introduced S. 590, the Relief, Equity, Access, and Coverage for Health (REACH) Act, with the support of both Democrats and Republicans—including Senators Bill Frist (R–TN) and John Breaux (D–LA).

Some proposals have integrated tax credits with other health care initiatives. Both President George W. Bush and Democratic presidential candidate Senator John Kerry (D–MA) have integrated tax credits into their overall health care proposals. Representative John Shadegg (R–AZ) has introduced the Small Business Access and Choice for Entrepreneurs Act (H.R. 3423), and Senator Jeff Bingaman (D–NM) and Representative Marcy Kaptur (D–OH) have introduced the Health Coverage, Affordability, Responsibility, and Equity Act (S. 1030 and H.R. 2402). All three combine the tax credit approach with an overall health reform proposal.

Step #2: Create alternative pools for the employees of small firms—including plans offered through churches, unions, and other intermediaries, as well as through the FEHBP—so that these workers and their families can access a wide range of affordable plans.

Providing a health insurance subsidy to employees who lack adequate help today is only one part of the solution to a lack of coverage. Affordable coverage that can be purchased with the help of a credit is the other part. For younger and healthier individuals and families, the individual insurance market offers affordable policies; but for many with poor health, obtaining affordable private coverage is difficult or impossible.

18. A recent study found that automatic enrollment for 401(k) plans boosted participation rates from 37 percent to 86 percent for such voluntary pensions, with even sharper increases for young and lower-paid employees. See Brigitte Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," National Bureau of Economic Research *Working Paper* No. 7682, May 2000, p. 51.

A solution to this problem is to construct forms of group insurance, in essence mimicking the large pools of employees available to the biggest employers. This would spread high risks across the pool so that sicker individuals and families would not face unaffordable premiums.

Enhancing the Stability of Groups. Creating such pools, however, poses a number of challenges that require careful design decisions. (Bringing several small employers together as a group poses similar challenges.) A major worry is the stability of voluntary insurance groups. The danger in bringing individuals together and establishing a group insurance premium—in effect, an average premium—is that healthier individuals would have the incentive to leave the group to get cheaper individual coverage reflecting their low risk. Meanwhile, sicker individuals would wish to join the group to get relatively inexpensive coverage. The group could then face a "death spiral" of ever-higher group rates.

Certain steps can reduce this problem to a degree. For example, some combination of higher rates, waiting periods, and pre-existing condition exclusions could be imposed on those seeking to join such a group who did not have prior coverage. Thus, individuals would be rewarded for buying and maintaining coverage when they are healthy and would be penalized if they sought coverage only when they needed medical care. Long-term contacts with penalties for dropping coverage could also make the group more stable.

A Reinsurance Pool with a Risk Adjuster. Although steps can be taken to improve the stability of pools, for long-term success and for equity reasons, an effective risk adjustment mechanism needs to be incorporated into group coverage for families in the small-business sector. A risk adjuster can take different forms, but the basic idea is to ensure that there are appropriate cross-subsidies between high-risk and low-risk enrollees within the pool, regardless of which insurance plan individuals choose.

An example would be a mandatory reinsurance pool in a state or other area, in which all insurers would pay a percentage of their premiums into a reinsurance pool and the member insurers would receive payments from the pool according to whether they had an above-average or below-average share of high-cost enrollees relative to the other carriers in that market. In this way, an insurer attracting a disproportionate share of high risks (perhaps because of good coverage for cancer) would be subsidized through the reinsurance pool by an insurer that attracted a disproportionate share of low risks (perhaps by offering a leaner policy with a lower premium).

Of course, if all carriers in the market were attracting about the same share of high-risk enrollees, then little—if any—cross-subsidy would occur through the reinsurance pool, since no single carrier or group of carriers was being disadvantaged in the market.

New Intermediaries in the Insurance System. Large firms are more effective than small firms in offering insurance not only because they can assemble large pools, but also because they are sophisticated negotiators and buyers of insurance. Insurance groups based on large organizations could achieve many of the marketing and administrative economies of scale that are normally available only to the employees of large firms. Typically, such organizations would not get into the business of insurance themselves, but would act much as a buyers club does by negotiating an arrangement with existing insurance companies. Organizations that might function in this way include groups of churches, trade unions, the American Association of Retired Persons (AARP), professional and trade associations, farm bureaus, and credit unions.

Some organizations (e.g., many farm bureaus) already offer plans, but working families who join these plans typically are not eligible for tax relief. Tax credits for health insurance would change that by making it more economical to offer insurance because far more potential enrollees would be able to afford premiums. For years, many African–American church congregations have organized various forms of insurance and other services for their members. Moreover, in many inner-city communities, these churches are typically larger, more stable, and more sophisticated—as well as more trusted—than the typical employer, making them

Why a Federal Reinsurance System Is Not the Answer

Some analysts and politicians have proposed that the federal government set up a national reinsurance pool, underwritten by the federal government. In effect, health plans could obtain federal insurance against the cost of paying for the treatment of very high-cost enrollees.

Under one such proposal, advanced by presidential candidate Senator Kerry, the federal government would create a "premium rebate pool" for employer-sponsored health insurance. The pool would reimburse employer health plans for 75 percent of the costs that surpass $50,000. To qualify for the reinsurance, however, employers must provide health coverage to all their workers, guarantee that the savings will be used to reduce workers' premiums, and implement a disease management program for employees.

There are several problems with such a federal approach when compared with a mandatory private reinsurance pool in which plans fund the pool and draw down funds according to their claims experience.

- A federal pool would shift the insurance risk to taxpayers. Instead of insurers (and employers) as a group covering the high-cost insurance claims, the government would take on responsibility for these commercial costs.
- The proposal would reduce incentives among employers and employees to control spending on claims that qualify for the rebate. Today, employers and employees are encouraged to be cost-conscious users of health insurance because of the high cost. However, if the government were to cover the majority of high-cost claims, employers and employees would have much less incentive to rein in costs and little incentive to be wise consumers of health care services. Removing or reducing the incentive to control costs and reduce risk could leave the taxpayer with huge liabilities—as the nation experienced in the savings and loan fiasco of the 1980s.
- To control the government's costs under such an arrangement, Congress would inevitably need to impose restrictions on the cost of specific services reimbursed by the federal reinsurance pool. This might take the form of a maximum allowable reimbursement for each service, as the government does now with Medicare. This would be the first step in applying Medicare-style uniform benefit design and command-and-control pricing to the private health market.

a natural avenue through which many families armed with tax credits could obtain their health insurance.

The FEHBP System as a Possible Model. The Federal Employees Health Benefits Program could be another model of an alternative intermediary for workers in small firms. The FEHBP is an example of an insurance arrangement that offers group rates for individuals and also incorporates plans offered through voluntary associations, primarily employee organizations and unions. An FEHBP "look-alike"—organized by states and that has a separate risk pool—could be one way to provide an insurance infrastructure.

The FEHBP provides federal workers and their dependents (nearly 10 million covered individuals) with a wide choice of plans.[19] There have been many proposals in recent years to open it up to

19. For descriptions of the FEHBP, see Harry Cain, "Moving Medicare to the FEHBP, or How to Make an Elephant Fly," *Health Affairs*, Vol. 18, No. 4 (July/August 1999), pp. 25–39; Stuart Butler and Robert Moffit, "The FEHBP as a Model for a New Medicare Program," *Health Affairs*, Vol. 14, No. 4 (Winter 1995); and Craig Caplan and Lisa Foley, *Structuring Health Care Benefits: A Comparison of Medicare and the FEHBP* (Washington, D.C.: AARP Public Policy Institute, May 2000).

non-federal workers under various conditions, typically using a separate insurance pool. To make the FEHBP available to non-federal workers using tax credits, Congress would need to amend federal law governing the FEHBP to permit a separate insurance pool for non-federal employees (so that premiums for federal employees would not be affected), with the exact structure in each state negotiated between the state and the federal government. Plans currently available in the FEHBP might be allowed to market to the new state pool if they wished, and other plans could market exclusively to the new pool provided they met the general requirements of the state-based version of the FEHBP.

Unions organize several of the leading FEHBP plans. For example, the Mail Handlers even offers associate membership to non-union members who wish to gain access to the health plan. These unions do not carry the insurance risk themselves; instead, they organize a group and negotiate an insurance package from an insurer for a fee. CNA Insurance organizes the Mail Handlers Benefit Plan, which has roughly 10 times as many enrollees as the union has regular union members. This "friendly society" role of unions has a long history in this and other countries.

Many union-sponsored plans also operate under the Taft–Hartley Act, where union-sponsored plans are a rational way to provide coverage when there is only a weak relationship between employer and worker. They flourish in markets that have fewer tax and regulatory obstacles to union-sponsored plans and where enrollees can receive tax or other subsidies—such as the FEHBP.

State governments could also charter FEHBP-style purchasing groups to act as intermediaries in their states, and a number of states are already experimenting along those lines with various purchasing group designs.

Step #3: Make it easier for employees to sign up for insurance in the workplace—even when the employer does not sponsor insurance—by removing tax and regulatory obstacles.

Most Americans pay their taxes through the workplace. This is a convenient system under which employers withhold income and Social Security taxes and send the money to the government. In addition, employees typically adjust their withholdings to take advantage of any tax breaks for which they may be eligible (e.g., the mortgage interest deduction). In a sense, the employers are actually operating the basic income tax system, but they do not in any sense design the tax code for their employees or "sponsor" the tax system. They could more appropriately be considered a clearinghouse for tax payments.

The place of employment is likewise particularly convenient and efficient for handling health insurance payments. Workers with employer-sponsored health insurance benefits typically sign up for the firm's plan when they take a job and arrange for a payroll deduction to cover premium costs for them and their families.

With individual tax credits for employees available, a small employer who is reluctant to sponsor coverage could instead carry out the critical clearinghouse role for the plan choices of his or her employees, making tax adjustments and premium payments. The employer might also decide to make a cash payment toward the plan chosen by the employee, as a fringe benefit.

Commonly, the payroll firm handling wages and benefits for the small firm would conduct these transactions. In this way, smaller employers could either directly or indirectly take responsibility for the mechanical aspects of arranging for payroll deductions and premium payments (similar to their role in the tax collection system) without having to sponsor a plan.

With tax credits, in principle, eligible employees could join any plan available in their area, not just one sponsored by their employer, and still obtain tax benefits. Thus, a small employer could play an important role in facilitating coverage without having to organize coverage by such things as providing information and making sign-up simple, instituting a payroll deduction and payment system (as many small firms do today for employee-directed savings plans), and making withholding adjustments to reflect available credits.

The government could spur the "facilitator" role of small firms that are disinclined to sponsor cover-

age themselves by clarifying the status of employer contributions to plans that are chosen by the employee and not sponsored by the employer. An employer wishing to set up such an arrangement today faces a dilemma. If the employer helps to pay for coverage chosen by the worker, that coverage is deemed to be an employer-sponsored plan under federal employee benefit law, and both the employer and the coverage issued to the worker by the insurer become subject to federal employer-sponsored plan regulations. To avoid such regulation, the employer must pay the worker taxable cash, which the worker can then use to purchase coverage. But that means the worker must forgo the tax benefit derived from his employer's making pre-tax contributions toward the cost of his coverage.

If the plan is interpreted as an employer-sponsored plan, the employer could face a regulatory nightmare under state insurance rules or the Employee Retirement Income Security Act (the federal law affecting certain employers) since any plan chosen by the employee would embroil the employer in complex insurance rules. However, if the arrangement is not considered an employer-sponsored plan, both employer and employee lose favorable tax benefits.

Thus, to encourage smaller employers to play the role of insurance facilitator—with or without a tax credit available to employees—federal and/or state employee benefit law needs to make clear that favorable tax benefits are available at least to the employee for an employer's contribution toward coverage whether or not the insurance is deemed an employer-sponsored plan.

Conclusion

High rates of uninsurance among working families in small firms are a testament to the limitations of the employment-based health system in the small-business sector. Yet both the tax system and government insurance rules discourage other insurance arrangements for these uninsured working families.

Proposals for individual tax credits for health coverage would help to remove this barrier to alternative insurance arrangements. In addition, taking steps to build an insurance infrastructure with affordable choices would enable these families to have coverage that is similar to—or even better than—the insurance available to employees of large firms.

With these reforms in place, new forms of coverage—including plans offered through churches, large corporations, and the FEHBP—would become available to working Americans in the small-business sector. For this to occur, however, Congress must recognize that an important distinction exists between using the workplace as a convenient location to obtain insurance and making tax relief to families contingent upon employer sponsorship of their health insurance.

—Stuart M. Butler, Ph.D., is Vice President for Domestic and Economic Policy Studies at The Heritage Foundation.

APPENDIX

Figure 1 B 1769

How the System of Employment-Based Insurance Would Change Under the Proposed Reforms

Current System

Large Business Sector

- Self-funded or purchased plans
- Multiple plans typical
- Low levels of uninsurance among workers

Small Business Sector

- Typically purchased plans
- Often no plan offered
- Typically no choice
- High levels of uninsurance among workers

Proposed System

Large Business Sector

No change

Small Business Sector

- Sponsors plan or
- Facilitates coverage through payroll deduction.

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New Insurance Infrastructure

- Workers have access to multiple plans through risk-adjusted pools, separate from the workplace.
- Refundable tax credits available to workers

Figure 2 B 1769

How Insurance Arrangements for the Employees and Dependents of Small Firms Would Change Under the Proposed Reforms