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STATEMENT OF

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Subject:	What Happens When Small Employers Receive Substantial Increases in Their Employee Health Insurance Premiums
Before:	Subcommittee on Employer-Employee Relations, House Committee on Education and the Workforce
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Committee on Education and the Workforce
U.S. House of Representatives

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Mr. Chairman, every measure of small business opinion of which I am aware conclusively shows that the primary concern of small employers is the cost of health insurance. This concern is not a recent phenomenon. But its intensity has grown remarkably in just the last four years. In the year 2000, the cost of health insurance headed a ranking of 75 possible small-business problems (Dennis, 2000). Forty-seven (47) percent of respondents to the survey from which that list was developed termed the cost of health insurance a critical problem. Within the last month, the NFIB Research Foundation published an up-dated list (Phillips). The cost of health insurance still headed the list, but by an even larger margin than in 2000. This spring the proportion terming the cost of health insurance a critical problem rose 19 percentage points to 66 percent. Clearly, the subcommittee is addressing a problem of enormous concern and interest to small employers.

I intend to focus the bulk of my remarks on small business responses to health insurance cost increases. The available data are not as extensive on this topic as desirable, but they lead us in important directions.

Health Insurance Cost Increases

The extraordinary run-up in health insurance costs over the last several years is well documented. Health insurance cost increases vastly outpaced increases in consumer prices or worker earnings over the last 15 years albeit with a brief respite in the mid-1990s. (Exhibit 1, drawn from the Kaiser Foundation/HRET annual survey, illustrates.) The practical effect of those differential increases is to leave those who pay the health insurance bill with substantially fewer resources to purchase other things, including non-covered health services.

Between 2002 and 2003, the cost of health insurance rose 13.9 percent, 15.5 percent for small employers (Kaiser Foundation/HRET). That means the average total cost of health insurance for a 10-employee firm (half individual coverage and half family coverage) rose on the order of $8,200. The $8,200 increase comes on top of a similar increase the prior year and an expected similar increase this year. Even deducting the typical employee cost share, the small-business owner would be looking at an increased bill for health insurance of about $20,000 over this three-year period. (If an employer in a 10 employee firm were to institute an average cost health plan with typical cost-sharing arrangements, the firm's share of the sticker shock would be $44,825.)[1]

[1] All calculations made by the author using 2003 premium data collected by Kaiser/HRET.

Given the magnitude of these costs, the immediate question all owners providing employee health insurance must ask themselves is:

1. What are my alternatives? and
2. How do I pay for what coverage I provide?

The Alternatives

The first small employer reaction to a substantial increase in premiums is to start shopping for a new plan, new carrier or even a new insurance agent/broker. Kaiser/HRET reports that in 2003, 62 percent of those employing between 3 and 199 people shopped for a new health insurance plan; 33 percent switched. A switch estimate for the prior year was 27 percent (NSBP; *Business Insurance*). A point to note is that small employers are the most likely of any employer size to shop and the least to switch. The implication is that while shopping often, the available alternatives are not necessarily enticing. Still, about half of the shoppers seemed to find something better.

A second type of alternative is use of non-traditional insurance mechanisms. Within the last year, NFIB collected a modest amount of data on small business use of three variants - Flexible Spending Accounts, Medical Savings Accounts, and reimbursement for some or all of privately purchased health insurance (NSBP; *Health Insurance*). Exhibit 3 shows that about 13 months ago, an estimated 9 percent of small employers with between 1 and 249 employees offered a flexible spending account, 5 percent MSAs and 13 percent some type of reimbursement. Larger, small employers were more likely to offer each than smaller, small employers. This size distribution likely means that proportionally more small business employees are eligible for the benefits than firms offering them.

Sample sizes make estimation of covered employees perilous. However, a reasonable, but very rough, estimate of the number of people employed by businesses that host these alternative programs are 8.9 million for flexible spending accounts, 3.9 million for medical savings accounts, and 7.8 million for reimbursement. Not every employee in these firms participate. Further, there is some overlap among programs. The totals, therefore, cannot be added to obtain an estimate of total employees impacted. Still, the number of employees exposed to these alternative insurance mechanisms indicates that small employers are changing rapidly and exposing a broad and large range of employees to them.

The different frequency of use by firm size is not surprising. Larger, small firms typically have greater administrative sophistication and more established human resources policies than smaller, small firms. That reimbursement, the simplest of the three alternatives posed, is proportionally used more frequently than the other two forms is evidence of the size effect.

NFIB currently has a small Health Savings Account program (including conversions from MSAs) for its members that is in its infancy. The good news I am told by people in Nashville who run the program is that 94 percent renew and cost savings for equivalent policies are about half. The bad news is that distribution is a problem. Agents do not like to sell these products due to their relatively low commissions, so NFIB has just 3,000 lives covered to date. A new distribution system has been devised and will soon be implemented. The program’s head expect the number of lives covered to rise exponentially.

Even if these options provide relief for small employers, many find it necessary to offset rising health insurance costs by other means.

The Limited Number of Potential Responses

The small employer, any employer for that matter, has a limited number of options from which to choose when facing cost increases for health insurance, energy, or even a government mandate. The most obvious is to pass-on cost increases in the form of higher selling prices. A second possibility is to reduce costs, such as cutting employee compensation or eliminating, postponing or trimming business investment. A third is to lower owner earnings. It is also feasible, at least theoretically, to increase sales (spread the cost increase over more units). Let us briefly review each in the context of health insurance.

Pass-On Costs (Raise Prices)

Raising prices seems to be the obvious solution for health insurance premium increases -- just let the customer pay the additional insurance cost a few pennies at a time. But if that were such an easy solution, business owners would be raising prices willy-nilly whether they received cost increases or not. Competition and the inflation environment affect the ability of any owner to raise prices. The more competitive the environment, the more difficult it is to raise prices. This is even more so when your cost increases are relatively greater than the competition's.

Small-business owners typically believe that they are in very competitive markets (NSBP: *Business Insurance*; NSBP: *Competition*). Moreover, the health insurance premium increases appear proportionally high for small compared to large firms, particularly when large firms are self-insured. (It should be noted that the cost comparisons between large and small are extraordinarily difficult to make given the internalization of many costs by large firms and the relative value of benefit packages offered.) However, premium increases are clearly proportionally high when firms compete against firms that do not offer employee health insurance. Since most without insurance are other small firms, and small firms are much more likely to be the primary competitor of other small firms (NSBP: *Competition*), the ability to raise prices is severely constrained.

An inflationary environment also makes price increases more viable. Business owners are more likely to plan further increases after realizing prior increases (Dunkelberg, Scott, Dennis) and customers expect them even if they do not like them. But inflation has been under control for over 20 years, and with a few exceptions small-businesses have had virtually no pricing power. Exhibit 2 presents the net percent of NFIB members who plan to raise average-selling prices in the next three months and the net percent whom actually did. Since 1982, but particularly since 1992, substantially more planned to raise prices than eventually did (could). The era was low inflation. Compare that to the 1974 - 1982 period when the opposite transpired. Small business has obtained a little more pricing power over the last few months. But if Mr. Greenspan has his way, that will not continue.

Reduce Costs

Payroll costs constitute an important cost for smaller firms. It amounts to about 30 percent of total business expenses in the median firm (NSBP: *Adjusting to Cost Increases*). When health insurance costs rise, it is possible to offset them by reducing payroll costs through such actions as employee lay-offs or failure to fill vacant positions (job loss), smaller raises or wage cuts, or a benefit reduction such as foregoing a pension plan, a greater employee cost share for health insurance, and even the elimination of employee health insurance.

The most common response to health insurance cost increases is to shift at least a portion back to employees in the form of greater cost sharing, higher deductibles and/or higher co-pays. (Economists tend to agree that both theory and empirical evidence indicate that a large share of cost of health insurance is shifted back to employees, though there is little evidence on precisely how the process works (Blumberg)). Kaiser/HRET reported that in 2003, 27 percent of small employers increased their cost share (65 percent of employers with more than 200 employees did), 24 percent hiked their deductibles, and 26 percent raised the co-pay for an office visit. NFIB reported that of those who found health insurance costs rising faster than any other type of insurance, 27 percent raised the employee cost share and 31 percent increased deductibles the prior year (NSBP; *Business Insurance*).

One option small employers did not chose in response to health insurance price increases was to drop employee health insurance. Just 5 percent of those without employee health insurance said that they dropped the benefit in the last three years (NSBP: *Business Insurance*). These data argue that declining coverage is not so much a phenomenon of benefit elimination, as of new businesses less often or later in life offering the benefit. Small employers do not like to take things away from employees once given. That is why not only premium price, but premium price uncertainty, is such a frequently cited reason for not procuring employee health insurance (Fronstin and Helman, Kaiser/HRET, NSBP: *Health Insurance*).

The fact that health insurance is infrequently eliminated does not mean rising health insurance premiums do not result in reduced coverage (and lost jobs). Increased premiums have that effect (Morrisey). However, the route appears is more indirect than eliminated coverage.[2]

(The 5 percent figure over three years cited above is much smaller than the 21 percent figure (in 2002, 12 percent in 2000) over the prior five years reported by EBRI (Fronstin and Helman). Part of the difference can be explained by the population surveyed, up to 249 employees in one and up to 50 employees in the other. Another is the question wording, dropped health insurance coverage and offered plan in the past. These differences are important and need to be reviewed, but the former appears to be closer than the latter if for no other reason than the abruptness of the jump between 2000 and 2002.)

Payroll is not the only important business cost. For example, physical facilities, i.e., the office, store, or plant, is another important cost that might be reduced. A large premium increase with more to follow might induce some owners to relocate to a less costly facility (though relocation costs may more than offset the savings realized for some period of time. In those circumstances, the change provides the business no immediate relief). Moreover, a central business strategy could be tied up in the location or appearance of a facility.

The difficulty with cutting other costs is the assumption that a business is currently wasting money and will stop it to pay for increased health insurance premiums. While priorities may dictate that other costs be scaled back to offset a premium increase, that trade-off goes to heart of production or sales. The most likely impact of such a move would fall on quality and service, and quality and service are the two basic strategies on which small businesses compete (NSBP: *Competition*).

[2]Owners of new firms appear increasingly reticent to offer health insurance. This push-back is significant because the business population constantly churns. About half of businesses die in the first five years and only one in ten reach 10 years old (Nucci). Every year about 800,000 new employers enter (about 5.8 million in the population) (SBA). If the owner of a new three employee firm chooses to pay a $10,000 health insurance premium, there is a strong likelihood the premium will be more the initial investment in the business (*Business Starts and Stops*).

Yet, another cost that could offset an increase in health insurance premiums is to eliminate, reduce or postpone business investment. This is the “eat the seed corn” strategy. Its effect is to impede growth or stimulate a downward spiral. Neither is good for the business, its employees, or the country. To the best of my knowledge, there is no data (except the little you will see later) that tells us the number of firms offsetting employee health insurance costs through smaller investment.

Lower Earnings

Lower earnings are not a viable option over the longer term. If earnings continue to absorb higher costs, earning gradually disappear. No earnings; no business; no need for employee health insurance!

But lower earnings often become a stopgap. While no one likes to take home less money this week than last, this year than last, small-business owners recognize that they do necessarily have a steady income. Their earnings fluctuate. But most small employers are middle-income people who cannot absorb another $5,000 or $10,000 year after year from their incomes to pay higher employee health insurance premiums.

In this regard, it is important to understand that a direct relationship exists between owner take-home and the provision of employee health insurance, establishment of an employee pension plan, and the average wage paid (Dennis, 1999). The more the owner takes home, the more likely the business is offer health insurance, pensions, and higher wages. The reverse is true as well. The corollary to this relationship is that the less profitable the business, the less likely it can use lower earnings to offset health insurance cost increases as even a stopgap measure.

Increase Sales

The idea of increasing sales to offset employee health insurance costs is to spread their cost over more units thereby minimizing the increase per unit of sales. But this option is not typically plausible because exercising it effectively assumes that the cost of increased sales is fixed rather than variable, and that the business is purposefully capping current sales. While theoretically possible, increasing sales is not a practical option in virtually any instance.

The Small Employer Choice

When presented these alternatives, what choices do small employers make? A sample of small-business owners was administered a series of hypothetical scenarios involving cost increases in 2001 (NSBP: *Adjusting to Cost Increases*). The question posed was how owners would handle cost increases under varying circumstances. The eight basic scenarios involved payroll cost increases and physical facility cost increases amounting to:

1. a 5 percent increase beginning in six months,
2. a 15 percent increase beginning in six months,
3. a 5 percent increase beginning next week, and
4. a 15 percent increase beginning next week.

Respondents chose the one action they were most likely to take from among: raising prices, cutting payroll costs, reducing earnings, or eliminating, postponing or delaying business investment.

The most appropriate scenario for present purposes, i.e., the closest to a substantial health insurance premium increase, is a 5 percent payroll hike beginning in six months. Under those circumstances 38 percent of small-business owners told interviewers that the most likely step they would take is to raise prices; 33 percent said that they would most likely cut earnings (which includes the volunteered response "do nothing"); 17 percent reported employees effectively would pay through lay-offs, not filling vacancies, the freezing or cutting of employee wages or benefits, etc.; and, 9 percent indicated that they would cut, eliminate or delay business investment (Exhibit 4). The remainder volunteered answers amounting to no more than one or two percentage points each, including cutting other business costs and increasing sales.

If owners were surprised by the magnitude of the payroll increase and had just one week to prepare for it, rather than the six months assumed above, about 10 percentage points more would reduce earnings and 12 percent less would force employees to absorb it. In other words, lower earnings would become the immediate cushion, though one can assume the shift back to employees over the longer term.

A five percent hike in payroll costs is more or less difficult to offset depending on payroll as a percent of total business expenses. Exhibit 4 presents the choices small employers would make under two scenarios with above and below median payroll, one with less lead time to implement and the other with more. The most important point in the exhibit is that when payrolls constitute a larger share of business expenses, owners are more likely to cut payroll costs. Similarly, when payrolls constitute a smaller share, they are more likely to absorb the cost through lower earnings.

Conclusion

Small business-owners struggle to pay the substantial increases in the employee health insurance premiums that now appear as regularly as the seasons. They have no single strategy to cope; they try to offset the increases as circumstances allow. Those circumstances include everything from the competitive environment (for sales and employees) to business earnings (profitability) to accurate forecasts of the next year's premium increase to expectations for the cost increases to be temporary or permanent. Too often, much of the initial cost is borne by the small employer. But that cannot continue and much is eventually shifted back to employees in one form or another. The most visible forms are greater cost-sharing, higher deductibles, larger co-pays and, possibly more stringent eligibility requirements. For the coming few months, it is likely that increases will more frequently be shifted forward to customers. Raising prices has limits, however, and cannot overtake back shifting as the primary offset vehicle.

It is important to recognize that whatever one thinks of insurance and/or insurance companies, insurance prices reflect the increased cost of health care. Therefore, it is critical that the rate of increase in health care costs be curbed. We need better value and better outcomes for the dollars we spend. But, health care is a scarce resource in the economic sense. The question is how are we going to ration that scarce resource and obtain the best outcomes possible. Are we going to ration it by having individuals make choices about health care use, or by insurance companies playing the "bad guy" by enforcing employer decisions, or by a government sponsored system like Canada that fails to provide adequate facilities and forces seriously ill patients to come to the United States for treatment.

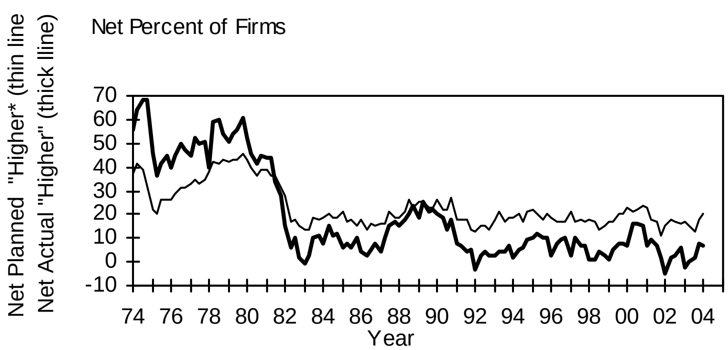
Exhibit 1
Annual Health Insurances Premiums Compared to Other Indicators, 1988 - 2003

Year	Health Insur. Premiums	Overall Inflation	Workers' Earnings
1988	12.0%	3.9%	3.1%
1989	18.0	5.1	4.1
1990	14.0	4.7	3.7

1993	8.5	3.2	2.5
- - -			
1996	0.8	2.9	3.3
- - -			
1999	5.3	2.3	3.5
2000	8.2	3.1	3.7
2001	10.9	3.3	4.1
2002	12.9	1.6	3.2
2003	13.9	2.2	3.1

Source: Kaiser/HRET

Exhibit 2
Planned and Actual Small Business Price Increases, 1974 – 2004



Source: Small Business Economic Trends

Exhibit 3
Use of Non-Traditional Health Insurance Mechanisms (Percent of Small Employer Population) by Employee Size of Firm

Non-Traditional Insurance Mechanisms	1 - 9 Employees	10 - 19 Employees	20 or More Employees	All Firms
Flexible Spending Accts.	6.5%	14.9%	24.1%	9.1%
Medical Savings Accts.	4.2%	5.6%	10.2%	5.0%
Reimbursement	11.4%	16.6%	17.5%	12.5%

Source: NSBP: *Health Insurance*

Exhibit 4
Responses to Hypothetical Five Percent Payroll Cost Increase Given Six Months and One Week Prior Knowledge by Firms with Above and Below Median Payroll Costs

a. Six Months Prior Knowledge

Response to Cost Increases	Below Median Payroll Costs	Above Median Payroll Costs	All Firms
Raise selling prices	40.3%	35.7%	37.8%
Reduce payroll costs	12.4	23.8	17.1
Cut business investment	6.0	8.4	7.2
Lower earnings	38.3	24.5	32.6
Other (including don't know)	3.0	7.6	5.3
Total	100.0%	100.0%	100.0%

b. One Week Prior Knowledge

Response to Cost Increases	Below Median Payroll Costs	Above Median Payroll Costs	All Firms
Raise selling prices	15.6%	20.0%	17.7%
Reduce payroll costs	12.1	17.1	13.3
Cut business investment	6.5	3.6	5.3
Lower earnings	61.3	51.4	56.4
Other (including don't know)	4.5	7.9	7.3
Total	100.0%	100.0%	100.0%

Source: NSBP: *Adjusting to Cost Increases*

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