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for the Self-Employed**

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Testimony of

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**House Committee on Small Business
"Health Care Reform in a Struggling Economy: What is on the Horizon
for Small Business?"**

February 4, 2009

Introduction

The plight of micro-business owners, those with ten or less employees, is becoming increasingly more challenging as our economy continues to decline. The pool of money these entrepreneurs have to draw upon for both business and family expenses has been dwindling, forcing many of the self-employed to make tough choices. The majority of micro-businesses are curtailing the purchase of inventory and equipment as well as downsizing staff or refraining from hiring additional help. In addition, a large percentage of micro-business owners are dipping into their savings to stay afloat, leaving their future retirement at risk. Most distressing is that many of the self-employed are scaling back their health coverage, and some are dropping coverage completely, in order to keep the doors of their business open and to pay for basic needs such as their home and utilities.

The cost of health coverage for micro-businesses plays a significant role as to why so many self-employed business owners go without or purchase a minimum coverage policy. In a 2008 survey, the National Association for the Self-Employed (NASE) found that micro-businesses are spending a median of 5.5% of their total sales on health insurance benefits, an increase of 48.6% since 2005. Additionally, this increase is most strongly felt by solo practitioners – they are spending 28.1% more of their total sales on health insurance compared to three years ago. With such a large percentage of revenues going to health coverage, we can see why this expenditure is one of the first to be decreased or cut when business owners are faced with hard economic times.

As discussions on health reform progress in the 111th Congress and within the Obama Administration, the National Association for the Self-Employed (NASE) would like to make clear that in order to improve the ability of micro-business owners to obtain quality health coverage, health reform proposals must address two key components: affordability and choice.

Premium costs are the single most important factor that determines whether a business owner will insure herself and provide coverage for her employees. Most importantly, if a micro-business owner cannot afford insurance for herself and her family, she will not likely provide health benefits to employees. The issue of choice or lack thereof in both carrier and plan options plays a role in terms of how they affect price.

How to Make Health Coverage More Affordable for Micro-Business

The common denominator for all small businesses regardless of size or business structure is that they all must pay taxes. The NASE strongly urges policymakers to utilize the tax code in efforts to reform our health system. The tax code is an excellent vehicle to provide financial relief to micro-business owners currently with health coverage as well as financial assistance to encourage those that are uninsured to purchase coverage.

A key step forward in addressing the affordability issue faced by the self-employed would be to tackle the current inequalities in the tax code that this segment of the business population faces as they attempt to purchase health coverage. According to the IRS, there are approximately 21 million sole-proprietors in the United States. At present, these self-employed business owners do not receive a full deduction for their health insurance costs and are also ineligible to participate in a Health Reimbursement Arrangement that they may set up for their employees.

Self-Employment Tax Deduction on Health Insurance

Sole proprietors are not able to deduct the cost of their health insurance premiums for the purposes of self-employment tax. Self-employment tax is FICA tax for the self-employed. The self-employed pay FICA at a rate equivalent to employees and employers for a total of 15.3 percent. While 100 percent deductibility of health insurance premiums has been phased in, it does not solve this tax inequity. Sole proprietors are required to pay two types of taxes on their annual tax returns: income tax and self-employment tax. One hundred percent deductibility relates only to income tax and not self-employment tax.

Sole proprietors are the only business entity that does not receive a full deduction for health care costs. All other business entities receive a deduction for health insurance premiums as an ordinary and necessary business expense for all employees, including owners. Employees and the owner pay for their health insurance premiums pre-tax, and therefore they are not subject to FICA taxes. However, sole-proprietors (Schedule C filers) do not receive this “business deduction” for health insurance premiums. The premiums are not paid with pre-tax dollars and are exposed to self-employment tax. Accordingly, the sole proprietor pays this tax (15.3 percent on self-employment income up to \$106,000) on his insurance premiums.

The most recent Kaiser Family Foundation study indicated that the self-employed pay on average \$12,106 annually for family health coverage. Because they cannot deduct these premiums as an ordinary business expense, they are required to pay \$1,852.22 in additional taxes that no other business entity must pay. This is money that NASE members tell us they would use to reinvest into their business, or utilize to offset the rising premium costs they face each year so they may hold on to their coverage a little longer. In these difficult financial times, removing this inequity would be a significant economic stimulus for the self-employed.

Health Reimbursement Arrangements (HRAs)

Discrimination against the self-employed also persists in Health Reimbursement Arrangements (HRAs). Health Reimbursement Arrangements are a flexible benefit option that allows small business owners to reimburse employees tax free for out-of-pocket medical costs, including health insurance premiums.

There are many benefits for a micro-business owner to set up an HRA for her employees. HRAs are often set up by small businesses in coordination with a high deductible health insurance plan. However, since many micro-business owners are unable to afford employer-based health insurance, a key benefit of an HRA is that they do not require the business owner to purchase a group health plan. Thus, business owners unable to afford insurance can offer some financial assistance to their employees.

HRAs are extremely flexible and easy for a micro-business owner to set up and administer. This is an important feature for a business owner who is responsible for managing every aspect of their business. Plan designs are limitless as long as they are consistent with IRS guidelines. A small business owner can write their own plan or obtain assistance from numerous vendors that offer prototypes of written HRA plans.

Since cost is such a crucial factor for micro-business when it comes to health benefits, an HRA gives the owner consistency when it comes to benefit costs. An HRA allows the business owner to determine the maximum amount of annual reimbursement an employee will receive, whether the HRA funds may be rolled over to the next year and if so, how much of an employees' HRA funds can be rolled over to the next year. Furthermore, the reimbursements are tax-deductible for the business.

At present, self-employed persons are not eligible to participate in an HRA; an inequity that negatively impacts millions of business owners and employees. While there are a myriad of generous self-employed business owners out there, a key rule of thumb is that an owner is unlikely to set up a benefit for employees that he is unable to participate in as well.

An important component of HRAs is the non-discriminatory rules that apply to them. If an HRA is set up, the benefits must apply to all employees. A business owner is not allowed to offer the benefit to only certain employees or allow some to have a higher amount of annual reimbursement. What is set forth in the plan will apply to all those working in the small business. Therefore, expansion of Health Reimbursement Arrangements to allow the self-employed business owner to participate in the plan would likely significantly increase the number employees of micro-businesses receiving health benefits and financial assistance with medical costs. Additionally, HRA annual reimbursement amounts would likely be more generous if the self-employed owner receives the same benefit.

Health Tax Credits

With the number of working uninsured rising every year, the NASE supports health reform proposals which include health tax credits to assist the self-employed in purchasing health insurance. Again, the primary reason small businesses go without coverage is cost. Tax credits would assist owners and individuals employed in businesses that do not have employer-sponsored health plans to afford health insurance. Since over

60% of our nation's uninsured work for small businesses or are the dependents of workers in small business, health tax credits would facilitate a large portion of our uninsured gaining access to coverage.

An effective tax credit must be advanceable, allowing eligible individuals to receive their credit every month, rather than in a lump sum at the end of the year, to let them buy coverage without incurring extensive costs during the year. The credit should also be refundable, allowing individuals that do not pay income taxes but are subject to payroll taxes to be eligible to receive the credit as a refund from the Internal Revenue Service. This would permit lower income workers who do not owe income taxes to receive the full value of the tax credit. The credit could be used to purchase coverage through the individual or group market, to buy into state purchasing pools, or to join an insurance pool in the private sector or one established by a state for high risk patients.

Health tax credits do not impose a one-size-fits-all standard, but instead seek to enable and empower individuals to choose the policies and features that most appeal to them and that work best for their business. As mentioned, choice is another key component desired by micro-businesses in health reform options. Only health tax credits would allow the self-employed to purchase insurance policies they own and control. The individual maintains choice of insurance carriers from which to purchase coverage, of doctors, and of services she wants covered.

Health care tax credits are a more cost-effective method of insuring workers who are able to pay some (but not all) of the cost of their health insurance and encourage business owners to provide an employer-sponsored health plan. The amount of the tax credit is essential to ensure affordability. A targeted tax credit can provide quality coverage to low- and middle-income families and self-employed individuals at a more modest cost.

How Insurance Market Reforms May Affect Micro-Business

As policymakers take a look at our health insurance markets as part of reform efforts, it is important that they consider the potential impact of market reforms on micro-business. Key debates are ongoing in regards to the use of pooling mechanisms, mandates and as to whether we take an individual and/or employer-based approach to health reform.

Individual vs. Employer-Based Coverage

The self-employed and micro-businesses purchase health insurance in two markets: the small group market and the individual market. The definition of a small group is determined by each state, though most define it as one with 50 or fewer employees. Firms in this size range looking to offer employer-based health coverage to their employees will look to the small group market for insurance options.

However, of those currently insured, the majority of self-employed and micro-businesses have purchased individual health coverage. According to the NASE 2008 Health Care

Survey, of the more than 46 percent of responding micro-businesses offering health insurance, only 18.6 percent offer coverage for full-time employees. That is a significant decline from 2005, when 46.2 percent reported covering full-time employees. What we see from this data is a definitive shift of micro-businesses from the small group market into the individual market. The high cost to both the business and the employee in terms of cost sharing are the top reasons for this shift.

The NASE believes that in order for health reform to be beneficial to the micro-business sector of the small business population, proposals must tackle the individual market. Key issues in the individual market are cost and underwriting based on health status.

State Mandates

Many states have a suitable number of carriers in the individual insurance market to offer the self-employed and micro-business owners an array of options. However, cost increasingly becomes an issue for business owners and workers in small businesses purchasing insurance on their own. While there may be some competition in states to allow for a range of pricing options, state mandates in the individual market result in high premium costs.

The NASE believes that the state regulatory climate plays a critical role in keeping costs high. State mandates on coverage in all markets increase the cost of basic health coverage from a little less than 20 percent to more than 50 percent depending on the state. The Council for Affordable Health Insurance has identified that there are currently over 1,600 mandates in our health care system. While mandates can make health insurance more comprehensive, they also make it more expensive by requiring insurers to pay for certain health services that consumers previously funded out of their own pockets. It is likely that insurers will push that added mandate cost into premium rates.

The cost that excessive mandates add to health coverage can mean the difference between a micro-business going uninsured or purchasing coverage. Additionally, the regulatory and statutory conditions in states have created barriers that make it difficult for new carriers and new products to expand into markets. Without new carriers or competing insurance products, prices will remain high when one insurance carrier dominates a market.

Health reform proposals must take a good look at the role that states play in our health care system. A balance must be struck between adding costly mandates and ensuring that critical health services are covered by insurance.

Pooling Mechanisms

The creation of pooling mechanisms, if properly formed, is another method that can be utilized in health reform proposals to begin addressing high costs and the lack of

negotiating power faced by the self-employed. Pooling arrangements would allow small business owners to band together to negotiate for better rates and better plan options. In addition, dependent upon how the pool was structured, it may also alleviate some of the administrative burdens of managing a health plan.

There have been previous legislative attempts to create pools via associations or organizations, as well as regional or state pools. In current reform proposals, discussion has centered on creating a national pool managed by the federal government to allow small business and individuals to purchase health coverage.

Micro-business owners are evenly split in their opinion on whether a government-run health option is the right approach. Chief concerns expressed are that the quality of their health care would not be as good or they would not have as many choices (i.e. plan options, doctors, specialists) in the government pool option. Also, micro-businesses are worried that if the federal government begins to manage our health care system, their taxes will significantly increase.

The NASE recommends that policymakers proceed with caution as they discuss the possibility of our federal government managing all or some components of our health care system.

Underwriting Based on Health Status

At present, the individual market requires underwriting based on health status. If you are a business owner or worker with a medical issue, your health premiums will likely be significantly higher in the individual market or you may be turned down for coverage, leaving you with minimal options to obtain insurance.

Tackling the issue of underwriting based on health status is complex. Some reform proposals have recommended that health insurance should be guaranteed issue, meaning that individuals cannot be denied access to coverage based on health status. This approach does have some negative consequences as it relates to affordability. Carriers are likely to charge higher premiums on guaranteed issue policies to allay potential costs related to undisclosed health issues. Though a self-employed business owner may now be able to access health coverage, it does not mean he will be able to afford it.

Improving and increasing funding for programs such as state high risk pools are a beneficial way of dealing with the population unable to gain access to health insurance in the current market due to health issues.

Mandates

Another option present in recent health reform recommendations has been the establishment of mandates, either for individuals or employers. As discussed earlier,

micro-businesses have a limited pool of financial resources to draw from for both business and personal expenses. Policymakers considering the use of mandates in their reform proposals must be mindful of the detrimental effect they may have on these smallest businesses in this current economic state.

The NASE does not support the mandating of health coverage at this time. In particular, an employer mandate to purchase and provide health coverage that does not exempt micro-business, those with ten or less employees, would be destructive to this important sector of the economy. To reiterate, based on NASE's 2008 health study, only 18.6 percent of micro-businesses nationwide were currently providing employer-based coverage to full-time employees. Consequently, an employer mandate would put millions of owners out of business and leave millions of workers unemployed.

The NASE believes an individual mandate would also be harmful in this current economic climate. However, such a mandate requiring all citizens to have health coverage may be more workable in the future if paired with a meaningful subsidy such as a health tax credit to help with affordability. In addition, the self-employed and micro-business owners must be able to purchase the coverage of their choice. Any attempts to restrict plan options in order to obtain the subsidy would make the mandate unworkable.

Conclusion

The National Association for the Self-Employed (NASE) strongly supports continued efforts to find proactive solutions to address the root causes of skyrocketing health costs in order to increase the number of insured micro-businesses. The self-employed and micro-business community continues to be the backbone of our nation's economy and immediate action must be taken to alleviate the massive health cost burden laid at their feet in order to ensure their survival.

As legislators begin their efforts to reform our health care system, we must realize that there is not a one-size-fits-all solution to this issue. The needs of the smallest businesses are not the same as those of a small business with 50, 100 or 200 employees. We must ensure that the policies created have the desired effect on the populations in need of the most assistance. The NASE recommends we proceed down the path of reform with diligence and with caution.