California HealthCare Foundation

Coverage Expansion

Is Small Business the Key to Insuring More Californians?

Issue Brief

Introduction

There is substantial interest among policy analysts and politicians in increasing health insurance coverage among Californians who work for small businesses.[1] Such firms are far less likely to offer health benefits than larger companies, leading some to suggest that persuading more small employers to provide health coverage could substantially reduce the number of uninsured people in the state.

This issue brief examines the potential to expand health insurance among California's uninsured through policies aimed at increasing the number of small employers that offer coverage. It provides information about the insurance status of employees in small businesses, the rate at which small employers offer health benefits, and the expected effects of policies designed to increase coverage within this group. As part of this analysis, it reviews the results of a recent experiment in San Diego in which small employers were offered the opportunity to purchase health insurance from a local HMO at reduced rates, a study designed to test the effectiveness of targeted subsidies.

The research finds that:

- Employees of small businesses that do not offer insurance account for only a modest fraction of the uninsured in California. Even if all such workers and their dependents were receiving health benefits, the number of uninsured in the state would drop by less than 20 percent.
- Although many small businesses do not offer health insurance, a considerable percentage of their employees do have coverage, primarily through a spouse or their own individual policy.
- Small employers are not very responsive to reductions in the price of health coverage. Even large subsides are likely to have a small effect on the number of businesses that offer health benefits.

The brief concludes that as a focal point for addressing the problem of California's uninsured, the small business market offers at best a small target. While some gains are possible, they are likely to be both limited in scope and difficult to achieve.

Findings

It is well known that small businesses are much less likely to offer coverage than larger businesses. As shown in Figure 1, in 2004 virtually all large California employers report offering health benefits to at least some of their workers, compared to 81 percent of firms with 10 to 49 workers and 55 percent of those with 3 to 9 employees.[2] These results suggest that if it were possible to increase offer rates among small businesses, the number of uninsured could be substantially reduced.

However small businesses that do not offer insurance account for only a small percentage of the uninsured in California. As shown in Figure 2, full-time workers and their dependents at small

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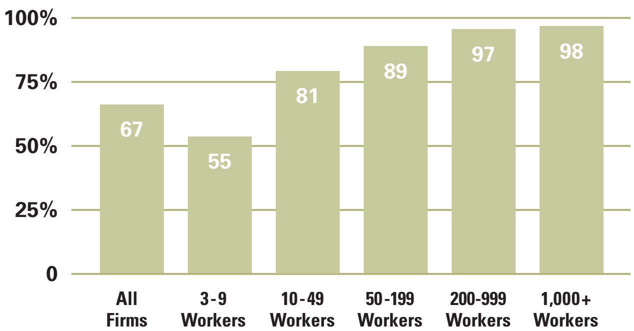
Figure 1. Percentage of California Employers Offering Insurance, by Firm Size

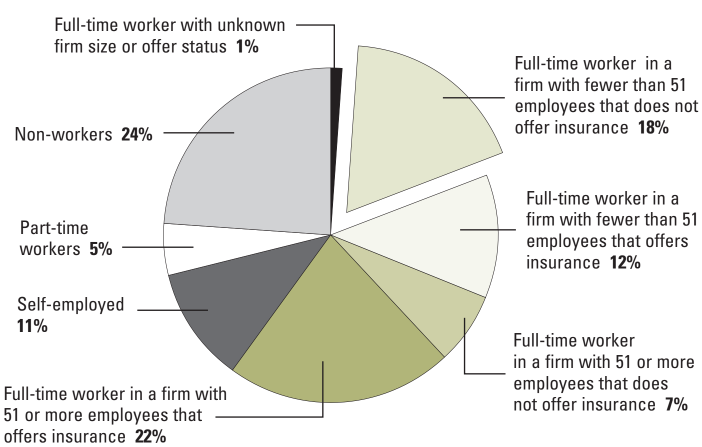


Source: CHCF/HRET California Employer Health Benefits Survey 2004.

businesses that do not offer coverage represent 18 percent of the uninsured in California. That is, if all businesses with fewer than 50 employees offered coverage, and all full-time workers accepted that coverage for themselves and their dependents, the number of uninsured would decrease by about one-fifth. That is a substantial amount, but most of the uninsured—about 80 percent—would remain uninsured.

It may seem surprising that small businesses not offering coverage account for only a modest share of the uninsured. This can be traced to a number of factors.

Figure 2. Family Work Status, Firm Size, and Offer of Employer-based Insurance Among the Uninsured in California, 2003



Source: 2003 California Health Interview Survey. Estimates provided by the UCLA Center for Health Policy Research.

Note: Numbers may not add to 100% due to rounding. Timeframe for work status is "last week." "Full-time" includes at least one full-time worker; "Part-time" includes at least one part-time worker and no full-time; "Self-employed" includes at least one self-employed person and no employees; "Non-working" includes families with no working adult (unemployed, students, retired, or disabled persons); age range is 0-64.

First, full-time workers at small businesses in California that do not offer insurance make up approximately 8 percent of the labor force; thus, even though they are more likely than other workers to be uninsured, they still do not account for a very large fraction of the uninsured (Figure 3). Second, although most large businesses and many smaller businesses offer insurance, some workers are not eligible for that coverage, and some who are eligible do not accept the coverage. Among full-time uninsured workers in firms that offer coverage, 57 percent report that they are not eligible for benefits, and 43 percent report declining coverage that is offered. Third, as was shown in Figure 2, the employment status of the uninsured is heterogeneous and includes sizable numbers of self-employed, part-time employed, and people not in the labor force.

Although there are many small businesses that do not offer insurance, substantial fractions of the employees in these businesses do have health coverage, either as a dependent on a spouse's policy; through an individually purchased policy; or, in some cases, through Medi-Cal, Medicare, or another government-funded health care program. As shown in Table 1, among a sample of small businesses in San Diego that did not offer insurance, approximately one-half of the full-time employees were insured, most as a dependent or through non-group coverage. Among the very smallest firms not offering coverage, approximately one-third of full-time employees are uninsured; in the relatively small number of firms not offering insurance with 11 to 50 employees, approximately three-quarters of full-time employees are uninsured.

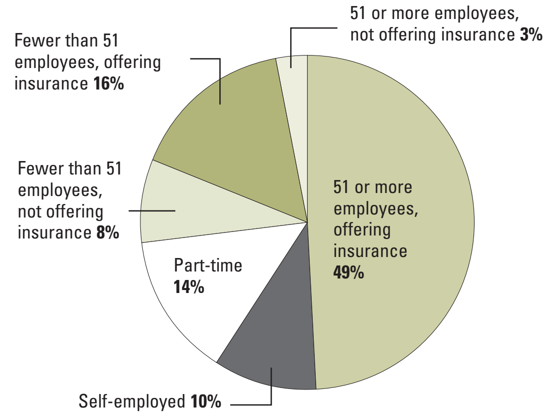
In summary, although there are many small firms that do not offer insurance, substantial fractions of the full-time employees at these firms do have health coverage. Further, because full-time employment in these firms accounts for less than 10 percent of total employment, and because there are many other pathways to living without health insurance,[3] full-time workers and their dependents at small businesses that do not offer coverage account for approximately one-fifth of the total number of uninsured in California.

Understanding the Coverage Decision

Even though increasing the availability of health benefits among small employers cannot eliminate the problem of California's uninsured, it remains a desirable goal. A number of politicians and policy analysts have been interested in offering subsidies to small businesses, either directly or in the form of tax credits, to encourage them to purchase insurance. The following discussion summarizes what is known about the effectiveness of subsidies in changing the behavior of small businesses.

Conventional economic theory posits that employers decide to offer some compensation in the form of health benefits, rather than in cash wages, if doing so will help the employer attract and retain the quantity and quality of workers needed to operate the business, consistent with the employer's desire to minimize the cost of labor.[4] According to this theory, employers will offer health coverage if the average worker in the firm would prefer to receive part of his compensation in the form of benefits rather than cash. Because most people want health coverage, group insurance is a much better buy than non-group insurance, and health coverage obtained through employment is tax favored; workers tend to view this as a fair bargain. As a result, most

Figure 3. Distribution of Workers in California, by Hours Worked, Firm Size, and Offering Status



Source: 2003 California Health Interview Survey. Full-time workers are those working 21 hours or more per week. Number of employees is the reported number at all locations in multi-establishment firms.

large and medium-sized employers, as well as many smaller ones, decide to offer health benefits as part of the compensation package.

However, some smaller businesses find that they can minimize labor costs and attract the workers they need without offering health benefits. This is particularly true for small businesses that employ many part-time workers, low-wage workers, or people who are likely to have coverage through a spouse. For a full-time worker, average 2004 premiums in California were $1.77 per hour for an employee-only policy, and $4.82 per hour for a family policy.[5] This would be a large fraction of

Table 1. Insurance Status of Employees at San Diego Small Businesses Not Offering Insurance, by Firm Size

Full-time Employee Insurance Status	Total	Firm Size (Number of Full-time Employees) 2 to 4	5 to 10	11 to 50
Uninsured	55.7%	31.2%	46.9%	77.5%
Insured	42.8%	66.1%	51.8%	21.5%
Individual Plan	*19.4%*	*33.9%*	*20.2%*	*9.6%*
Relative / Spouse	*18.2%*	*27.0%*	*25.4%*	*7.3%*
Medi-Cal / Medicare	*3.1%*	*2.7%*	*3.4%*	*3.1%*
Other / Unknown	*2.2%*	*2.5%*	*2.8%*	*1.5%*
Status Unknown	1.5%	2.6%	1.2%	1.1%
	100%	100%	100%	100%

Source: UCSD survey of San Diego employers, 2001.
Note: Unweighted N = 492. Insurance status of workers as reported by owner.

compensation for many low wage workers, and it is not surprising that many businesses that employ primarily low-wage workers do not offer health benefits.

It makes sense to think that if small employers were provided with subsidies for the purchase of health insurance, then some that do not now offer coverage would start doing so. Consider, for example, the choices facing an employer whose workers' wages average $10.00 per hour, and for whom insurance will cost $1.75 per hour. Suppose also that the employer feels the need to provide an average $0.50 per hour raise next year, either because the work is getting more complicated and the skill needed from workers is increasing, or because wages are going up in general. In the absence of subsidies for insurance, the employer can only start offering the benefit if he substantially reduces wages, and many workers are likely to be extremely unhappy if their wages are cut, even if they are offered health coverage as compensation. Thus, in the absence of a subsidy, the employer will likely offer the $0.50 raise in cash. However, if the employer is offered, for example, a $1.00 per hour subsidy towards the cost of health insurance, the employer might decide to provide the $0.50 per hour towards the cost of the benefit, take advantage of the $1.00 per hour subsidy, and allow those workers who value health coverage to pay $0.25 per hour towards the cost of the premium.

As this example illustrates, whether the employer will start offering insurance in response to subsidies depends on two crucial factors. The first is the need to provide a raise to employees. Unless the subsidy fully pays for the employer's share of the premium cost, the employer will be required to provide a raise to employees in order to start offering insurance. Although economic theory might suggest that the business could compensate for an employer contribution to health insurance by reducing wages, as a practical matter, it is very unlikely that employers can do so, even if they are able to point to the availability of health benefits as compensation for a wage reduction. Thus, employers will only respond to subsidy offers if they see the need for increasing total compensation by the amount of the required employer contribution.

The second factor governing the insurance decision is whether a particular business can more easily attract and retain workers by providing the raise as cash or in the form of health benefits. It is clear that the availability of subsidies for the purchase of insurance will increase the number of employers who opt to put an anticipated pay raise into health benefits rather than cash. The key question is how large the response will be, and to what extent the response varies with the size of the subsidy offered.

The Effectiveness of Subsidies

Approximately 15 years ago, a set of pilot programs in a dozen sites around the country offered subsidized health insurance coverage to small businesses that did not provide insurance.[6] Although the projects varied substantially, in many sites the subsidies offered were approximately 50 percent of the full premium. The results were disappointing: in most sites the estimated take-up rate was 5 percent or less of the eligible businesses. However, it is likely most were unaware that subsidized insurance was available, and a reliable estimate of the take-up rate among those who were aware of the subsidy could not be obtained.

A variety of researchers have used observational data in an attempt to estimate the extent to which small employers respond to variations in the price of insurance.[7] The observational studies for the most part conclude that small employers are not very responsive to price cuts. Typically, even fairly large reductions in price result in quite modest increases in the fraction of employers who choose to offer coverage. While the observational studies support the conclusions of the pilot programs conducted in the late 1980s, the results of the observational studies are not wholly convincing. They do not provide a direct answer to the question of how many employers would start buying insurance if subsidies were made available, because they are unable to observe the behavior of employers under such conditions.

Results of a Randomized Experiment

In an attempt to provide direct evidence about the effectiveness of subsidies, in 2000 the California HealthCare Foundation funded the University of California, San Diego and Sharp Health Plan to conduct a randomized experiment in San Diego. The project was called Financially Obtainable Coverage for Uninsured San Diegans (FOCUS). In this experiment, small employers were given the opportunity to purchase health insurance, at subsidized rates, from Sharp Health Plan, a San Diego-based HMO. To be eligible for the subsidy, the employer was required to:

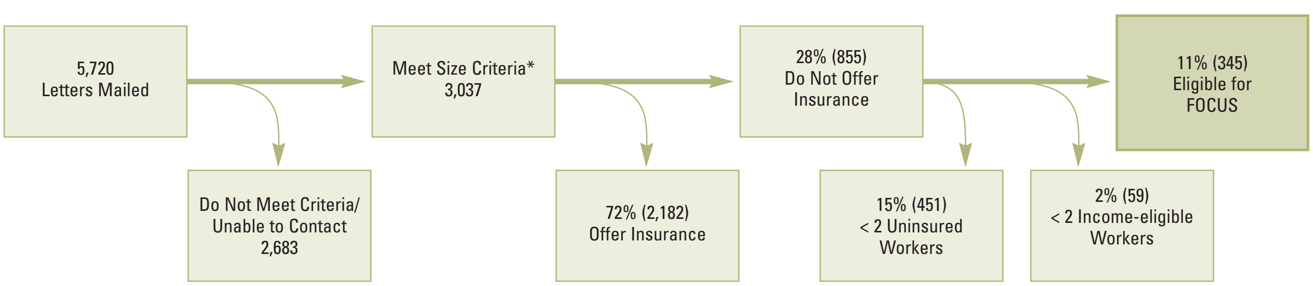
- Provide no health coverage;
- Have between two and 50 full-time employees; and
- Have at least two full-time employees who were uninsured and had family income below 300 percent of the Federal Poverty Level.

Eligible employers were offered subsidized insurance coverage. The market price of the policy was approximately $145 per month for a single employee. Drawing from a sample of small businesses provided by Dun & Bradstreet, employers were randomly assigned to experimental groups in which the amounts that employers and employees were required to pay were different. In the most generous scenario, the average combined premium payment was approximately $20 per month; in the least generous scenario, approximately $100 per month.[8]

Among the businesses that employed between two and 50 full-time employees, 72 percent reported offering insurance (Figure 4).[9,10] Many of the businesses that did not offer insurance had only a few employees and at most one uninsured worker, while some had fewer than two uninsured employees with incomes below 300 percent of the Federal Poverty Level.

It is estimated that 345 businesses were eligible to purchase FOCUS, representing approximately 11 percent of the firms employing two to 50 workers. As expected, the study found that more small businesses purchased coverage when the combined employer and employee payment averaged $20 per month than when the combined payment was $80 per month. But even at $20 per month, only about 40 percent of the businesses eligible to purchase the insurance actually did so

Figure 4. Estimates of Business Eligibility for FOCUS-Subsidized Insurance



Source: UCSD Survey of Small Employers in San Diego, 2001.
*Businesses with 2 to 50 full-time workers.

(Figure 5). At $80 per month, an estimated 13 percent of eligible businesses bought coverage. Among businesses in which the owner was uninsured, the response was much greater, varying from close to 80 percent purchasing coverage at $20 per month, to approximately 40 percent purchasing coverage at $80 per month. However, only 17 percent of businesses had an uninsured owner, and thus the overall response among small businesses was dominated by the response in businesses in which the owner was insured.

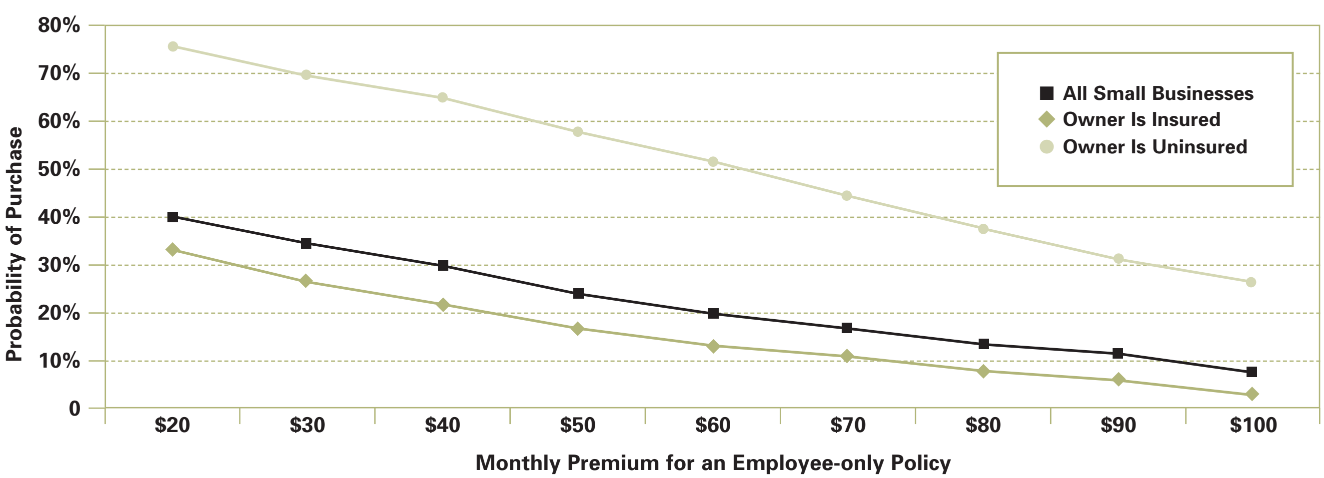
Given that the market price for the policy was approximately $145 per month, it may be a surprise that the response was not greater. For example, a policy of $50 per month is approximately a two-thirds subsidy, but at this level the research results suggest that only 25 percent of eligible businesses would purchase coverage. In the sample of businesses studied, approximately 72 percent already offered coverage. Thus, offering a two-thirds subsidy might induce one-quarter of the remaining businesses to start offering, bringing the overall offer rate up to approximately 80 percent.

In part, the muted response might have been the result of various features of the study. First, there were multiple attempts to notify each business owner about the offer, including at least two mailings (on joint Sharp Health Plan/UCSD letterhead) and at least two phone contacts. Even so, some eligible employers probably never got the word—they may have thrown out the mailings without opening them and refused to talk to project staff on the phone. If all eligible owners had known about the offer, the response might have been greater; however, if the owners had any interest in offering insurance, it is likely that the aggressive marketing efforts would have been sufficient to get their attention.

Second, the subsidized prices were guaranteed for a two-year period and some owners may have been concerned about what would happen at the end of two years; it might be that a program that could promise subsidies in perpetuity would have garnered a stronger response. However, only one owner who rejected the offer mentioned a concern about the two-year limit in response to a question about why they did not purchase coverage.

Third, the limited response may have been due, in part, to the administrative complexity of the subsidy program, in which employees were required to declare their family income in order to determine the level of premium they would have to pay. However, few of the non-purchasing owners cited complexity as a barrier.

Figure 5. Probability of Purchasing Insurance, by Premium Cost and Owner Insurance Status



In part, the response may reflect a lack of employee demand. One owner of a South Bay firm with approximately 20 employees, primarily young Latino men, was interested in offering the product. Approximately one-half of the employees were willing to pay the employee share of the premium, while the other half did not want to purchase coverage. The owner agreed to offer the benefit and absorb the employer's share. However, the employees who did not want to pay for coverage then argued that the owner should give them a raise equivalent to the employer's cost. At this point the owner threw up his hands and walked away from the deal.

That story is the exception. For the most part, it appears that owners did not purchase coverage because they were operating their businesses satisfactorily without it. As discussed above, in the short run, a decision to start offering health benefits is equivalent to providing a raise—an employer who starts contributing $30 per month for health insurance is unlikely to be able to reduce employee wages by $30 per month in compensation. Many owners apparently did not feel the need to provide a raise at the time they were offered the opportunity to purchase subsidized coverage, even when a relatively small employer contribution would leverage a substantial subsidy.

If a subsidy program were permanently available, it is at least theoretically possible that the response would be larger. Part of the limited take-up during the study period may have been due to timing—at the time the product was offered, many owners were not planning on giving their workers a raise. Over a long enough period of time, many businesses do need to offer some additional compensation to workers in order to stay competitive. It is theoretically possible that if the subsidy offer were continuously available, then a larger fraction of owners would take advantage.

Conclusion

The evidence from the experiment conducted in San Diego, from earlier demonstration programs in a dozen sites around the country, and from a wide range of observational studies suggests that small employers that do not offer insurance are not very responsive to reductions in the price of coverage. While the evidence from any one of these studies can be criticized, and none of the work provides a definitive basis to estimate the likely response to some of the tax credit proposals that have been made by politicians of both parties, the breadth and depth of the evidence is enough to convince most health service researchers that employer response to health insurance subsidies would not be large.

Most firms with relatively well paid employees who have strong preferences for insurance already offer coverage; many firms that do not offer coverage are primarily staffed by low-income employees for whom the full cost of insurance is far beyond their willingness or ability to pay. It makes sense to think that subsidies will convince more firms to start offering insurance, but that number is likely to be small. (Even if it were possible to ensure that all full-time workers at small businesses that do not offer coverage obtained insurance, more than 80 percent of the uninsured would remain uninsured.) Further, it appears to be very difficult to use offers of subsidized coverage to hit this target effectively—even large subsides are likely to result in only modest increases in the number of businesses that decide to provide health benefits.

ENDNOTES

1. At the federal level, President Bush has proposed creating Association Health Plans in an attempt to increase offering rates among small businesses. Senator Kerry, while running for President in 2004, proposed tax credits for small businesses, and Congressional Democrats have made a similar proposal in 2005 *John Kerry's Health Care Plan*. More recently, Congressional Democrats in 2005 proposed a plan with subsidies for small businesses (Kaiser Daily Health Policy report, May 5, 2005. www.kaisernetwork.org/daily_reports/rep_index.cfm?hint=3&DR_ID=29852, May 10, 2005.) A variety of state governments have proposed, and, in a rare cases, enacted, limited subsidy programs for small businesses. (See Neuschler E., Curtis R. "Use of subsidies to low-income people for coverage through small employers." *Health Affairs*, Web Exclusive. 2003. 22(4); Silow-Caroll S, Waldman EK, Meyer, JA. *Expanding employment-based health coverage: lessons from six state and local programs*. The Commonwealth Fund, Issue brief #445. February, 2001; Swartz K. Healthy New York: Making insurance more affordable for low-income workers. The Commonwealth Fund, Issue Brief, #484, November 2001.) In California, a 2005 bill proposed by Assemblymembers Joe Nation and Keith Richman (AB 1670) included a proposal for subsidies to small employers with low-wage workers.

2. The estimate that 55 percent of businesses with between three and nine employees do not offer coverage is quite sensitive to the definition of "employee." In the CHCF/HRET survey, both part-time and full-time workers were included in the count of number of employees. Most of the businesses in the three-to-nine employee category are on the lower end of that range and many primarily use part-time workers. If the analysis were restricted to businesses with at least three full-time workers, the percent offering coverage would increase substantially.

3. These include not being a member of the labor force, self-employment, employment in a larger firm that does not offer coverage, and being ineligible for the benefit or unable to afford the employee portion of the premium in a firm that does offer coverage.

4. See, for example, Feldman R, Dowd B, Leitz S, Blewett LA. The Effect of Premiums on the Small Firm's Decision to Offer Health Insurance. *Journal of Human Resources* 32(4): 633-658; Autumn, 1997.

5. The 2004 California Health Benefits Survey reports average premiums for employer-sponsored insurance of $3,685 for single coverage and $10,013 for family coverage. The numbers in the text divide these figures by 2,080 hours.

6. Helms WD, Gauthier AK, Campion DM. Mending The Flaws In The Small-Group Market. *Health Affairs*, 1992. 11(2) 8-27. Thorpe KL, Hendricks A, Garnick D, et. al. Reducing The Number Of Uninsured By Subsidizing Employment-Based Health Insurance: Results From A Pilot Study. *JAMA* 267(7): 945-948. 1992.

7. See, for example, Hadley J, Reschovsky JD. Small firms' demand for health insurance: the decision to offer insurance. *Inquiry*. 2002 Summer; 39(2):118-37.Gruber J, Lettau M. 2000. *How elastic is the firm's demand for health insurance?* Working Paper #8021. Cambridge, MA: National Bureau of Economic Research. Leibowitz A, Chernew M. 1992. The firm's demand for health insurance. In *Health Benefits and the Workforce*. U.S. Department of Labor. Washington, DC. Jensen JA, Gabel JR. State mandated benefits and the small firm's decision to offer insurance. *Journal of Regulatory Economics*. 1992. 4: 379-404. Marquis MS, Long SA. To offer or not to offer: the role of price in employers' health insurance decisions. *Health Serv Res.* 2001. 36(5): 935-958.

8. In each group, the required employer payment was a fixed dollar amount for an employee-only policy, a fixed dollar amount for an employee-plus-spouse policy, and a fixed amount for an employee-plus-children policy. The required employee payment depended both on the experimental group and on the employee's income; employees with more income were required to pay more than lower-income workers. There were five scenarios for employers and five for employees, with 25 scenarios in total. In some scenarios there were low employee and low employer payments, in some scenarios relatively larger payments for both employer and employee, and some scenarios were mixtures of generous subsidies for employees, less generous for employers, and vice-versa.

9. Project staff initially sent letters to 5,720 businesses. Approximately one-quarter did not have a valid phone number, and approximately the same fraction did not have between two and 50 full-time employees (most of the latter group were sole-proprietorships with no full-time employees other than the owner).

10. A 2000 CHCF/Mercer survey of employers with between two and 50 employees reported that 69 percent of small employers in California offered coverage. The relatively small difference between that estimate and this study's 72 percent offering rate estimate for San Diego may reflect real differences between small employers in San Diego and those in the rest of the state or, more likely, small differences in data collection methods.

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