

The Patient Protection and Affordable Care Act: Will Small Business Need Protection from Its Cost?

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Executive Summary

We examine the Patient Protection and Affordable Care Act from the perspective of the direct and indirect cost implications for small businesses. We find that the reform's mandate will raise overall costs, and that the structure of the mandate and tax credit will raise effective marginal tax rates on small business growth and expansions. In addition, the burdensome and intrusive 1099 reporting requirements will burden firms, alter the customer relationships in the small business market, and impose potential strains on employee relations in the small business sector.

These cost pressures will be exacerbated by the indirect effects of the reform. Small businesses will face unmistakable upward pressures on health insurance premiums and the need to re-work benefit packages. Indeed, in the extreme some may choose to exit providing insurance altogether. Simply mastering the information necessary to make these decisions will be a substantial hurdle for many small businesses.

As businesses react to the changed economic landscape, there will be natural incentives to attempt to shift the higher costs to customers, workers, or business capital. At least for the near term, the ability to charge higher prices appears limited. Instead, one would expect that the effective burden will be borne by workers in the form of lower wage growth, fewer hours, or even reduced job growth. If not, the burden will fall on scarce business capital, raising the prospect of increased failure rates of small businesses.

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Introduction

The Patient Protection and Affordable Care Act (PPACA or “health care reform”) is sweeping legislation that will affect economic activity far beyond the one-sixth of the U.S. economy identified as health care sectors. The health care reform includes individual and firm-level mandates for health insurance coverage, extensive insurance industry regulation, creates new state-level programs and obligations, two new large federal entitlement programs, and dozens of new federal boards and commissions.

This paper is devoted to documenting the channels by which health care reform is likely to reshape the landscape of operating costs facing small businesses. Health care reform will mean some direct costs for small businesses in the form of mandates, penalties, and compliance costs. In the other direction, there will be a temporary offset for some small businesses in the form of a 50 percent tax credit for the cost of employee insurance.

Direct cost impacts are not the only important channel of impacts on small businesses. Perhaps just as important are indirect impacts on business costs through higher insurance premiums, the need to restructure compensation packages due to the incentives of the health care reform law, and the time and resources that will be dedicated to simply learning about the requirements of the PPACA.

These additional costs come at a crucial time. The U.S. economy has suffered a severe recession. Although top-line GDP growth resumed in the 3rd quarter of 2009, net private job growth has been stubbornly slow and unemployment remains elevated. Millions of discouraged workers have departed the labor force in response to anemic hiring.

Small businesses are widely-recognized as a traditional source of job creation. For example, using data from the ADP Employment Report one

finds that since January of 2001, firms having 1 to 49 employees have on average contributed 33 percent of monthly employment growth, while those with 50 to 499 employees contributed 50 percent. Depending on one’s definition of “small”, the average ranges from 33 to 83 percent. Cutting the data slightly differently, since January of 2001, the smallest category (1 to 49 employees) was responsible for 36 percent of cumulative job growth, while the group of somewhat larger firms (50 to 499) is credited with 44 percent. By any metric, small business hiring is crucial to the labor market fortunes of American workers.

These same ADP data point to the importance of small business in the nascent recovery. Non-farm private employment growth turned positive in February 2010 in the ADP series. Since then, the economy has added 157,000 jobs. Of those, 28,000 came in the smallest firms and 109,000 in the next larger grouping. Small firms are responsible for 87 percent of net job creating in the recovery thus far. Substantial new costs that curtail this hiring should be of concern to companies, workers, and policymakers alike.

The remainder of this paper is organized as follows. In section 2 we highlight the direct costs of the PPACA and provide rudimentary guidance to the magnitudes that appear to be at stake. Section 3 contains a similar discussion of indirect cost impacts. In section 4 we discuss the potential for small business to shift these costs, and the resultant impact on consumers and workers that might prevail. The final section is a summary with conclusions.

Direct Costs of the PPACA Insurance Costs

From the employer perspective, the most celebrated aspect of the PPACA is its mandate to cover employees with health insurance. Focusing first on those employers with more than 50 workers,

beginning in 2014, those firms must pay a penalty if any of their full-time workers receive subsidies for coverage through the exchange. The penalty is equal to the lesser of \$3,000 for each full-time worker receiving a premium credit, or \$2,000 for each full-time worker, excluding the first 30 full-time workers. The fees are paid monthly in the amount of 1/12th of the specified fee amounts. Firms with fewer than 50 employees are exempt from the so-called employer “play or pay” penalties if they do not offer coverage and their workers receive a subsidy in the exchange.

From the perspective of economic performance, the most important point is that the best possible impact is that the firm is already offering insurance, no individual ends up receiving subsidies and triggering penalties, and thus costs are unaffected. In every other instance, health insurance will compete with hiring and growth for the scarce resources of those firms.

One might think that the same situation prevails for the smallest firms – those under 50 employees – who are exempt from the coverage mandate. Unfortunately, for these firms, the greatest impact is to create a tremendous impediment to expansion. Suppose for example that a firm does not provide health benefits. Hiring one more worker to raise employment to 51 will trigger a penalty of \$2,000 per worker multiplied by the entire workforce, after subtracting the first 30 workers. In this case the fine would be \$42,000 (21 (51-30) workers times \$2,000). How many firms will choose not to expand?

Proponents of the PPACA like to point toward the fact that small businesses will receive aid in the form of a small businesses tax credit, ostensibly offsetting the burdens outlined above. Unfortunately, the credit is available only for employers with fewer than 25 workers and those in

which average earnings are under \$50,000. Thus, the cost and growth impacts for those with 26 to 50 employees remains unchanged. Moreover, the credit is not a permanent part of the small business landscape. An employer may receive the credit only until 2013 and then for two consecutive tax years thereafter. Thus, the credit is available for a maximum of six years.

Turning to the credit itself, to be eligible the employer must pay at least 50 percent of the premium. The credit is equal to 35 percent of employer contributions for qualified coverage beginning in 2010, increasing to 50 percent of the premium in 2014 and thereafter. The amount of the credit is phased-out for firms with average annual earnings per worker between \$25,000 and \$50,000. The amount of the credit is also phased-out for employers with between 10 and 25 employees.

The combination of requirements for premium contributions, limitations on employees, limitations on earnings, and phase-outs has surprised the small business community. In particular, the reform’s strict definition that a firm is only a small business if it has 25 or fewer employees proved convenient to the legislators who crafted the bill. This narrow definition has led to a number of studies that assert that more than 80 percent of small businesses will be eligible for the tax credit.

Even those studies that recognize the limitation imposed by the 25-employee limit tend to overstate the likely penetration of the credit. For example, the Small Business Majority and Families USA recently estimated that 84 percent of the nation’s 4.8 million businesses that employ 25 or fewer employees will be eligible for the tax credit.¹ Unfortunately, the net impact of the credit in offsetting the cost burden of the PPACA will depend not upon eligibility but rather on receipt of

¹ http://www.smallbusinessmajority.org/_pdf/tax_credit/Helping_Small_Businesses.pdf

the tax credits. This distinction was noted early in the debate by the Congressional Budget Office. In November 2009 when the law was being considered before Congress, CBO found that, “A relatively small share (about 12 percent) of people with coverage in the small group market would benefit from that credit in 2016.”²

A more useful study focuses on the estimated number of small firms who would qualify for the small business health insurance tax credit. A recent analysis conducted by the National Federation of Independent Business (NFIB) found that the total number of firms that offer health insurance and pay more than half of their employees’ premium costs, as mandated under PPACA, is more likely 35.0 percent of all firms with less than 25 employees.³

In the same way that the mandate provides an implicit tax on growth, the structure of the small business tax credit will raise the effective marginal tax rate on small business expansion. For this reason, the credit may discourage firms from hiring more workers or higher-paid⁴ workers. Consider two examples.

In the first, employers will have an incentive to avoid increases in the average rate of pay in their firm. Suppose that the average wage in a small (3 worker) firm is \$25,000 and the owner decides to add a more highly paid supervisor being paid \$50,000. This will raise the average wages in the firm to \$31,250 there by reducing the tax credit per worker from \$2,100 to \$1,596.⁵ In effect, the structure of the credit raises the effective cost of adding valuable supervisory capacity.

In this example, total credits to the firm are essentially unchanged (\$6,300 to \$6,384) by raising the average wage. If the new supervisor were paid \$75,000 however, total credit payments would fall from \$6,300 to \$4,368. The lesson is clear in that the structure of the credit can impose large effective tax rates on raising the quality of the labor force for those receiving the small business credit.

Similar incentives affect the decision to hire additional workers because the overall tax credit falls by 6.7 percent for each additional employee beyond 10 workers. This is a very strong disincentive to expanding the size of the firm. Using the example above, suppose that the firm has 10 employees and total credits received were \$21,000. The firm’s total subsidy will peak at \$21,840 with the hiring of the 13th worker. Thus, a firm employing 13 workers would get a total tax credit of \$21,840 while a firm employing 24 workers would receive a total credit of only \$3,360.⁶

The upshot is that the small business tax credit is a mixed economic blessing. Relatively few firms will qualify for the credit and be able to offset the costs of health insurance. For those that do qualify, receipt of the credit imposes a new regime of hidden effective marginal tax increase on improvements in scale and quality.

Administrative Costs

Perhaps the most expensive and intrusive new cost on small business is contained in Section 9006 of the PPACA. This adds a new information reporting requirement mandating that business will have to issue Forms 1099 for goods purchased after 2011, regardless of the corporate form of the

² <http://cbo.gov/ftpdocs/107xx/doc10781/11-30-Premiums.pdf>

³ <http://www.nfib.com/nfib-on-the-move/nfib-on-the-move-item?cmsid=52099>

⁴ The PPACA raises effective marginal tax rates in the labor more generally. See, for example, Holtz-Eakin and Smith [2010]. http://americanactionforum.org/files/LaborMktsHCRAAF5-27-10_0.pdf

⁵ This example assumes the employer contributes \$6,000 toward insurance for each employer.

⁶ <http://www.ncpa.org/pdfs/ba703.pdf>

vendor. Vendors of goods will have to furnish, and business will have to collect Tax ID numbers for all aggregate purchases totaling over \$600 annually. If a vendor fails to furnish a correct Tax ID, the business receiving the goods is required by law to impose back-up withholding at the rate of 28 percent of the purchase price. This means that businesses will now have to keep records of all purchases and keep them sorted by Tax ID.

This costly expansion of administrative requirements has nothing to do with the objectives of health care reform. Thus, it is best viewed as an initiative in tax administration. From this perspective its inclusion is puzzling as neither the National Taxpayer Advocate nor the Treasury Department recommended this 1099 legislation that extends information reports to vendors of goods. The Office of the Taxpayer Advocate is concerned that the new reporting burden, particularly as it falls on small businesses, may turn out to be disproportionate as compared with any resulting improvement in tax compliance.⁷

The health care reform's 1099 provision would apply to businesses of all sizes, charities and other tax-exempt organizations and government entities. Based on tax returns filed in 2009 for tax year 2008, more than 41 million organizations will now need to submit 1099 forms. This will be an administrative nightmare for businesses and non-profit organizations.

Moreover, it is not obvious that the Internal Revenue Service will be able to make productive use of this new volume of information reports. In general, the IRS' document matching system compares amounts shown on a taxpayer's tax return with amounts shown on third-party information reports like the form W2. Under this new provision, the amounts on the 1099 information reports will not match the tax returns.

Thus, from a tax administration perspective, it is exceedingly doubtful that the Section 9006 mandate comes close to making sense from a benefit-cost perspective. However, the greatest concern is the hidden impact of the 1099 provision on the operation of small businesses. For example, small businesses seeking to minimize recordkeeping burdens now have an incentive to use large vendors that can produce Tax ID reports for them. As a result, small business that lack that capacity to track customer purchases may lose customers, leaving the economy with more large national vendors and less local competition.

Alternatively, consider the impact of tracking employees' purchases of minor items like gasoline or taxi cab services. In each instance, it will be necessary for employees to ask service personnel to identify their ownership so that the business can identify when total purchases aggregate to \$600 over the course of the year. The total tracking burden will quickly become onerous for startup and growing firms. At the same time, employees will find their every action implicitly monitored by the 1099 compliance requirements, raising the specter of strains on management-employee relations.

Indirect Cost Effects of the PPACA

As the previous section documents, small businesses will face higher costs and effective tax rates under the requirements of health care reform. At the same time, the overall environment in which they operate will likely become more costly due to the provisions of the PPACA.

The first impact will be increases in health insurance premiums due to the reforms under the PPACA. Beginning in 2010, insurers will be required to cover the costs of pre-existing conditions in dependents, limitations on annual and lifetime benefits, and retaining children on their

⁷ <http://www.irs.gov/newsroom/article/0,,id=225270,00.html>

parents' policies up to age 26. In each case, the direction is clear – covering more costs – even if the magnitudes remain to be determined. As costs become higher, the inevitable result will be more expensive premiums for small businesses.

More generally, the PPACA is modeled quite closely on the reforms in Massachusetts.⁸ For the small business community, then, it is troubling that the Retailers Association of Massachusetts reports that state insurance premiums for small businesses have rose about 15 percent annually over the past five years. These increases presage the pressures that will become evident in the years to come.

Beginning in 2014, the reform prohibits the practice of “medical underwriting,” a process whereby insurers can deny coverage or charge higher premiums on the basis of health status. PPACA requires insurers to guarantee issue and renewal of coverage to all applicants without imposing pre-existing health condition exclusions – provisions beneath the premium pressures in Massachusetts. Similarly, the PPACA requires all plans selling individual or small group coverage to participate in a risk adjustment system that applies to all insurance sold in these markets (including those sold in the exchanges.) The risk adjustment system collects funds from plans that have a disproportionately low risk population and transfers these funds to plans accumulating a disproportionately costly population. As the overall risk pool becomes more expensive, no small business will escape the upward pressure on premiums.

The second impact of the PPACA will be to provide strong incentives to re-work the compensation packages of existing employees. The reform specifies a minimum “essential” benefits package for coverage sold in the individual and

small group insurance markets. The health care law specifies a list of services that must be covered. The Secretary of HHS will be required to review and update these lists of covered services on a regular basis.

A majority of employers can anticipate making plan design changes. Employers will have to discontinue lifetime maximums, annual dollar maximums, cost-sharing for preventative services and lower the cap on the amount that employees can contribute to their health care flexible spending accounts. According to Mercer, a leading global health benefits consulting firm, an analysis of its 2009 National Survey of Employer-Sponsored Health Plans found that 62 percent of small businesses have at least one red flag in their plan design that violates PPACA's mandates and 14 percent of small businesses have two red flags. Similarly, 38 percent of small businesses are at risk for incurring “unaffordable coverage” penalties, which are assessed when employee premium contributions are greater than 9.5 percent of the average annual salary in the organization.⁹

In short, many employers will find themselves in the position of having to provide more benefits, absorb a greater fraction of total costs, and re-work their insurance provisions. In light of this, it is worth noting that many employers may decide to drop employer-sponsored insurance altogether. As noted by Holtz-Eakin and Smith [2010] there are strong financial incentives for employers and employees to mutually agree to shift coverage to the subsidized exchanges.¹⁰ While doing so has long-run financial advantages, it will involve substantial short-run churning in labor markets and compensation structures.

The final perspective is that small business owners will have to master a wide variety of new

⁸ See the debate between Jonathan Gruber and Douglas Holtz-Eakin, *Journal of Policy Analysis and Management*, forthcoming.

⁹ <http://www.mercer.com/summary.htm?idContent=1378875>

¹⁰ http://americanactionforum.org/files/LaborMktsHCRAAF5-27-10_0.pdf

requirements and incentives. At present, substantial confusion exists regarding the reforms mandates and the requirements imposed on each business. At a time when the small business community is struggling to overcome the challenges of a financial crisis and credit freeze, a deep recession, the reporting requirements of the stimulus legislation, and the prospect of higher taxes if the 2001 and 2003 tax laws are permitted to sunset, these demands shift their focus from the basic mission of expansion and growth.

The Response of Small Businesses to Higher Costs

The previous sections have outlined the direct and indirect cost pressures that will prevail under the health care reform. Small businesses will react to these incentives in order to prosper to the greatest extent possible. In the process, there will be attempts to shift these burdens away from the businesses themselves. That is, the ultimate cost of the PPACA's small business provisions may be shifted to other parties.

One obvious strategy is to raise prices to cover the newly-imposed costs, thereby shifting the costs to consumers. At present, economic weaknesses undercuts pricing power, making it unlikely that this channel will prevail for some time to come.

However, to the extent that the economy recovers, shoppers relying on small business goods and services will find prices stiffening to match health insurance cost increases.

An alternative route will be to pass increases in healthcare costs to workers in the form of slower wage growth. Of course, it may not be possible to pass along the full cost in the form of lower wages. If a full-time worker is at or near the minimum wage, it will not be possible to offset higher costs

with lower wages. Instead, employer's will be forced to shorten hours or drop workers altogether. The Lewin Group estimates that there will be a loss of employment between 157,300 and 366,200 people if PPACA were fully implemented in 2011. Specifically for small businesses (less than 500 employees), Lewin estimates that employment losses will be between 50,200 and 113,000 jobs.¹¹

The final possibility is that small business owners will attempt to absorb these cost increases out of scarce capital. In this instance, the reduced liquidity (especially at a time of credit market tightness) will raise the probability of the failure of small businesses.¹²

Summary and Conclusions

This short paper has reviewed the provisions of the PPACA from the perspective of the direct and indirect cost implications for small businesses. We find that the reform's mandate will raise overall costs, and that the structure of the mandate and tax credit will raise effective marginal tax rates on small business growth and expansions. In addition, the burdensome and intrusive 1099 reporting requirements will burden firms, alter the customer relationships in the small business market, and impose potential strains on employee relations in the small business sector.

These costs pressures will be exacerbated by the indirect effects of the reform. Small businesses will face unmistakable upward pressures on health insurance premiums and the need to re-work benefit packages. Indeed, in the extreme some may choose to exit providing insurance altogether. Simply mastering the information necessary to make these decisions will be a substantial hurdle for many small businesses.

¹¹ <http://www.lewin.com/content/publications/LewinGroupAnalysis-PatientProtectionandAffordableCareAct2010.pdf>

¹² The importance of capital market constraints is demonstrated in Holtz-Eakin, Douglas, David Joulfaian, and Harvey S. Rosen. 1994. "Sticking it Out: Entrepreneurial Survival and Liquidity Constraints." *Journal of Political Economy* (February):53-75.

As businesses react to the changed economic landscape, there will be natural incentives to attempt to shift the higher costs to customers, workers, or business capital. At least for the near term, the ability to charge higher prices appears limited. Instead, one would expect that the effective burden will be borne by workers in the form of lower wage growth, fewer hours, or even reduced job growth. If not, the burden will fall on

scarce business capital, raising the prospect of increased failure rates of small businesses.

As the review makes clear, far too little is known regarding the magnitudes of many of the costs and resultant adjustments. An important agenda for the research community is to follow the evolution of the new law and provide accurate measurement of its actual impact.

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