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**HEALTH INSURANCE:
Availability and Adequacy
for Small Businesses**

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Issues

Before the
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the Environment
Committee on Energy and Commerce
House of Representatives

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Summary

Small businesses are having an increasingly difficult time offering health insurance which meets the needs of their employees. This is the result of rapidly increasing costs of health care and changes in the insurance market, especially the use of strict underwriting standards by insurers.

About half of small businesses with less than ten employees do not offer health insurance coverage to their employees, with cost being the primary reason cited for not doing so.

Compared with larger companies, small ones have been particularly hard hit by several closely related factors, including:

--the inability to spread risk over a large number of employees and the consequent greater chance that just one or two employees with serious illnesses will lead to huge premium increases,

--the increase in the use of insurance premiums that are based on the experience of individual companies (experience rating) rather than the broader community (community rating).

--competition among insurers for businesses that present lower risk, and consequent higher costs for businesses with worse experience.

Insurance pricing mechanisms also constitute a major problem for small business. This market is characterized by businesses frequently changing or otherwise leaving their insurance companies, a process known as "churning." While many small businesses simply go out of business, others periodically choose new insurers who offer lower rates. This competition may eventually exclude some employees, however, because insurers may use medical underwriting criteria to exclude employees with preexisting conditions (including illnesses developed under coverage of the previous insurer). Culling out less healthy employees makes the initial costs for a small business policy relatively low. From the second year onward, however, the firm's employees begin to develop illnesses that are covered, leading to higher costs for the insurers and higher premiums, and shopping for a new insurance company again. The net result is a reduction in the effective amount of health insurance coverage.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss problems which small businesses have in providing health insurance to their employees. Because of the concern that restrictive changes in health insurance plans by both small and large firms may increase the numbers of Americans who lack adequate health insurance, you and Chairman Dingell asked us to begin an examination of the major health policy initiatives being adopted by the private sector. That study is currently under way. Today's focus is on small business, and we will provide some preliminary findings on the problems that employees of small businesses face in obtaining adequate and affordable health insurance coverage. While all firms are having problems with rapidly rising health care costs, our preliminary findings indicate that the workings of the small business insurance market create unique problems for small firms that exacerbate the impact of rising costs affecting firms of all sizes.

As the Committee is well aware, health care costs have been increasing rapidly. These increases in health costs have led to more than an eight-fold increase in business health spending between 1970 and 1987. Such rising health costs have adversely impacted firms of all sizes. But small firms and their employees have been particularly hard hit. A National Association of Manufacturers survey found that 1988 health care costs for firms with less than 25 employees increased by 33%--- a rate of increase one and a half times the rate experienced by the nation's largest firms.

Probably the most important effect of rising costs is the inability of a substantial number of employees of small firms to obtain group health insurance. The smaller the firm, the less likely it is to offer health insurance. A recent Small Business Administration (SBA) study indicated that only 46 percent of businesses with less than 10 employees offered health coverage. In contrast, according to SBA almost all businesses with 100 or more employees offered health insurance. Almost half of the working uninsured are employed by businesses with fewer than 25 employees. Of the 8.2 million uninsured private wage and salary workers in 1984, 3.9 million were employed by a firm with fewer than 25 employees.

Erosion of the Small Business Health Insurance Market

Problems with the cost and availability of insurance are in large part consequences of the nature of the small business health insurance market. A confluence of factors is leading to the erosion of the health insurance market for small employers. These factors include:

- -- the inability to spread risk over a large number of employees,
- -- the decline of the availability of community rated health insurance products,

-- competition among insurers to offer coverage only to the best risks.

Insurance is used to spread risk. It is probable that in a sizable population, relatively few people will incur substantial health care costs. The losses of these few are shared among many, as covered individuals (or their employers) make regular payments into an insurance fund from which payments can be made. Small firms, because they are insuring only a few individuals, are less able to take advantage of this pooling of risks. Therefore, when insurance premiums are based on the experience of individual small companies, those companies with even a single employee with high costs can be adversely affected because of their small risk pool.

In the past this dilemma has been avoided through a system known as community rating--a mechanism for spreading risks more broadly. Under community rating the premium is based on the average cost of actual or anticipated health care used by all subscribers in a particular geographic area, industry, or other broad grouping and does not vary for subscribers within each grouping. Therefore, an individual firm's premium generally is not further adjusted for such variables as its own claims experience or the health status of individual workers. Blue Cross plans in most states have traditionally provided community rated plans available to small firms.

Greater competition in the insurance marketplace has led to the erosion of community rating. Commercial insurers were able to select from the community pool small businesses who were better risks and offer lower rates, thereby raising the rates for the higher risk firms remaining in the pool. As commercial insurance companies continued to siphon off the firms with the lowest expected health costs, the ability to spread risks in community rated plans diminished. As a result, community rated health insurance products became less available. Even Blue Cross/Blue Shield plans have had to reduce the extent of community rated health insurance. Risk pools have become increasingly narrow as insurers attempted to take the better risks and base premiums on the expected utilization of a small risk group. This in turn has adversely affected those small firms whose employees have had higher than average medical costs.

Restrictive Underwriting Practices

Small businesses are currently in a market where some insurers are attempting to move costly industries, firms or individuals out of their pool through restrictive underwriting practices.[1] Medical underwriting often results in the exclusion of some employees from coverage if they have preexisting conditions such as cancer, diabetes, heart disease or other high cost illnesses. In some cases such individuals may be denied any coverage, and in other cases only the specific preexisting

[1]Underwriting generally refers to insurance companies' criteria and decisions as to which risks to accept or exclude from coverage.

condition is excluded. This underwriting may also limit the coverage available to spouses and dependents of the employee.

Another underwriting practice employed by some insurers of small firms is to exclude selected types of businesses. Among the many types of businesses that various insurers exclude are taxi companies, taverns, roofing companies, hair stylists, and medical offices. The exclusions, however, vary widely among insurance companies.

Even when a firm and its workers have health insurance, they may still be affected by their insurance company's underwriting practices. Policies are written for a set time and at the end of that term some insurance companies may subject covered individuals to medical underwriting criteria. This practice, known as "renewal underwriting" can result in exclusion of coverage for any person who has developed an expensive medical condition while he or she is insured.

Turnover, Pricing, and Underwriting

Because of the factors discussed above, workers in small businesses may face particular problems when their employers change insurance companies or when they change employers.

Rapid turnover of the firms insured by an insurance company, known as "churning," is a fact of life in the small business health insurance market. Based on our discussions with several companies who provide insurance to small businesses, it appears that about a third of the insured firms leave these insurance companies or are not renewed each year. A large number of small firms fail and go out of business. Others shop for better price and/or service.

Insurers told us that one of the major contributors to churning is durational rating or the "wear off of underwriting." Because of medical underwriting and preexisting condition exclusions, first year costs for a small business policy are considerably lower than the costs for subsequent years. In the second and subsequent years some preexisting condition exclusions expire and the covered population begins to develop new conditions leading to higher costs. Higher costs generate the need for rising premiums. In the face of these higher premiums, many small businesses respond by seeking a new insurer who will offer them a lower first year rate. Problems for employees will arise if they had a serious illness or even a pregnancy which began under the lapsing insurance contract. These employees may well find themselves excluded from necessary coverage under the new insurance company.

Similar problems occur for workers who are changing jobs or who have recently lost their job. Providing transitional coverage is another important issue for small business. They have higher labor force turnover rates and longer waiting periods before health coverage begins than larger firms do. Further, at termination of employment small firm employees usually do not have the option of continuing their health insurance coverage at group rates. For firms with 20 or more employees, the