EXECUTIVE OFFICE OF THE PRESIDENT
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THE ECONOMIC EFFECTS OF HEALTH CARE REFORM ON SMALL BUSINESSES AND THEIR EMPLOYEES

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EXECUTIVE SUMMARY

Small businesses play an important role in the U.S. economy and are a strong driver of job growth and innovation. But small businesses are severely disadvantaged by the current U.S. health care system relative to their larger counterparts. A new report by the Council of Economic Advisers (CEA) examines the challenges faced by smaller firms under the current health care system, and the likely impacts of health care reform on small businesses and the workers they employ. Key findings of the report include the following:

Small businesses are crucial to the economy.

- Small businesses are an important source of job growth in the United States. Firms with fewer than 20 employees accounted for approximately 18 percent of private sector jobs in 2006, but nearly 25 percent of net employment growth from 1992 to 2005.

- Small businesses account for a large majority of jobs in start-ups, a key source of innovation and economic growth.

The current health care system is not working well for small businesses and their workers.

- The U.S. health care system imposes a heavy "tax" on small businesses and their employees. Due to high broker fees, fixed administrative costs, and adverse selection, small businesses pay up to 18 percent more per worker than large firms for the same health insurance policy. Some of these higher costs are passed on to small firm employees in the form of lower wages, and some eat into the profits of small businesses that could otherwise be used for research and development and for much-needed investments. This implicit tax disadvantages small firms in both the market for the best workers and the market for their products.

- Because of their higher health care costs, small businesses are far less likely to provide health insurance for their workers than larger businesses. Only 49 percent of firms with 3 to 9 workers and 78 percent of firms with 10 to 24 workers offered any type of health insurance to their employees in 2008. In contrast, 99 percent of firms with more than 200 workers offered health insurance. Consistent with this pattern, 29 percent of non-elderly adult workers at firms with fewer than 25 employees were uninsured in 2007. In that same year, just 10 percent of workers in firms with 500 or more employees were uninsured. Workers at small firms that do offer health insurance also tend to have less generous plans than workers at large firms.

- The fraction of small firms offering health insurance has been declining in recent years. From 2002 to 2008, the fraction of firms with 3 to 9 employees offering health insurance to their workers declined from 58 to 49 percent.

<u>Health care reform as envisioned in current draft legislation would reduce the current burdens on small firms and their workers</u>.

- Small businesses that meet certain criteria would be able to purchase health insurance through an "insurance exchange" – allowing them to choose among a multitude of plans that would provide better coverage at lower costs than they could find in the current small group market.

- Many small businesses that provide health insurance for their employees would receive a small business tax credit to alleviate their disproportionately higher costs and encourage coverage. The tax credit would be targeted to those firms with employees whose average wages fall below a certain threshold.

- The current reform options include financial incentives for medium- and large-sized firms to provide health insurance coverage through so-called "pay-or-play" provisions. Firms with payrolls or employment levels below a certain threshold, which would include the vast majority of small businesses, would be exempt from the pay-or-play provisions.

- The creation of an insurance exchange would also provide better and lower-cost options for workers in small businesses that do not offer health insurance. Low-income individuals and families would receive sliding scale subsidies to help them purchase insurance. Additionally, health insurers would not be allowed to screen potential enrollees for pre-existing conditions.

- The proposed reforms could help spur entrepreneurial activity by increasing the incentives for talented Americans to launch their own companies, and could increase the pool of workers willing to work at small firms. Further, successful reform would reduce the phenomenon of "job lock," in which workers are reluctant to leave a job with employer-sponsored health insurance out of fear that they will not be able to find affordable coverage. Small firms that are unable to provide health insurance for their employees bear the greatest cost of this phenomenon.

- Reductions in absenteeism and improvements in worker productivity resulting from better health outcomes because of expanded coverage would particularly benefit small businesses.

I. INTRODUCTION

Small businesses are an important driver of job growth and innovation in the United States. Unfortunately, the current U.S. health care system does not work well for these firms or their employees. Small businesses pay significantly higher insurance premiums and, as a result, are far less likely to offer health insurance to their workers. Properly designed health care reform has the potential to improve the competitiveness of small businesses and the economic condition of workers in this crucial sector of the economy.

In this report, the Council of Economic Advisers (CEA) examines the likely impact of health care reform on small businesses and their employees. We begin by documenting the key role that small businesses play in job creation and the difficulties they face in the current health insurance system. We conclude that small firms are seriously disadvantaged relative to their larger competitors because of the higher premiums that they must pay to provide health insurance for their workers. Workers in small firms are more likely to be uninsured or, if their employers do provide insurance, to have less generous policies.

One way that small businesses and their workers will benefit from health care reform is that it will improve the overall performance of the economy. For this reason, we review the evidence that health care reform that slows the growth rate of costs and expands health insurance coverage will improve living standards and take-home pay for families, prevent unsustainable increases in the budget deficit, and improve the efficiency of the labor market.

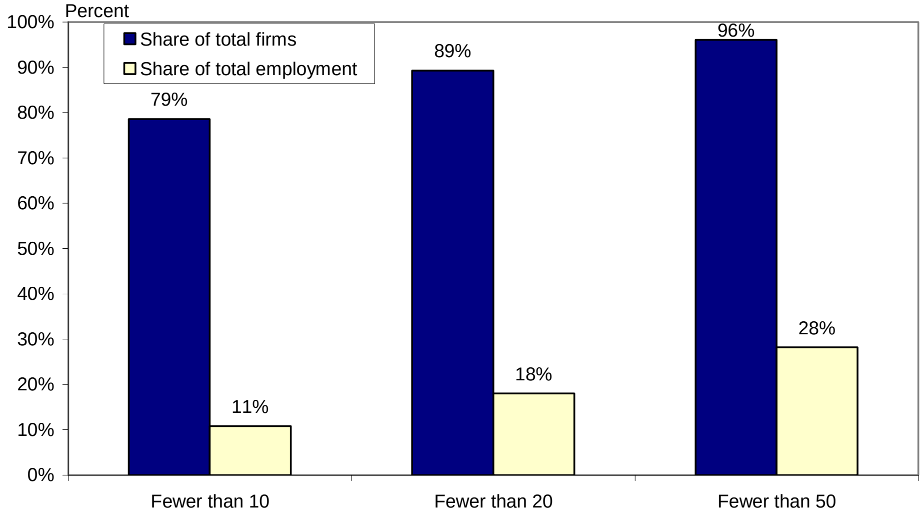
We then examine the effects of health care reform on small firms in particular. We find that the proposed legislation currently under consideration in the House and Senate is likely to help small businesses be more competitive in the American marketplace and improve the standard of living of workers in small firms.

II. THE IMPORTANCE OF SMALL BUSINESSES TO THE U.S. ECONOMY

Small businesses play an important role in the U.S. economy. Two common measures of the size of a firm are its number of employees and its annual payroll. By either measure, the vast majority of firms in the United States are small, and these firms account for a substantial share of private sector employment. Figure 1a shows that, measured by employment, 89 percent of firms had fewer than 20 employees in 2006, and these same firms accounted for 18 percent of private sector employment. Similarly, those with fewer than 50 employees accounted for 96 percent of all firms and 28 percent of private sector employment. Even firms with fewer than 10 employees accounted for more than 3 out of every 4 firms in the United States.[1]

[1] U.S. Small Business Administration (2009a).

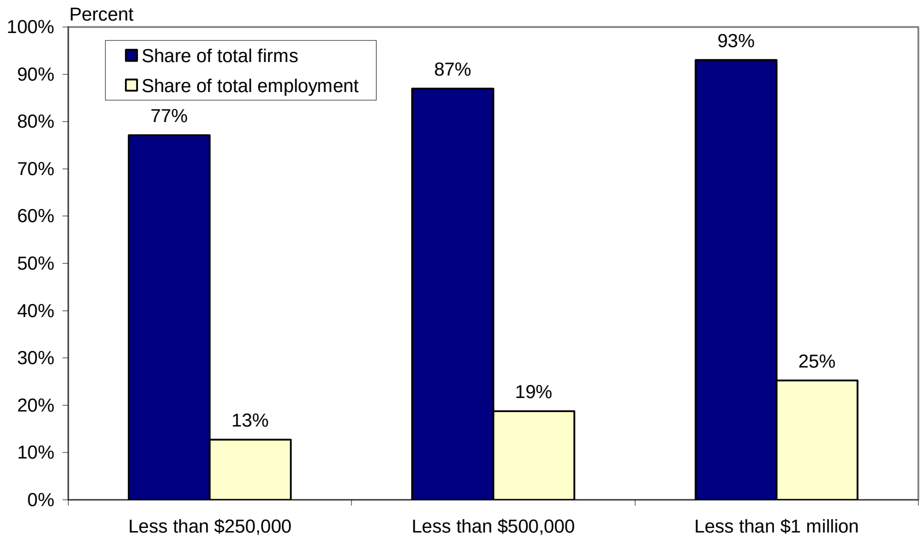
Figure 1a: Share of Total Firms and Total Employment by Number of Employees, 2006



Source: U.S. Small Business Administration. "Employer Firms, Establishments, Employment, and Annual Payroll Small Firm Size Classes."

A similar pattern emerges if one defines firms by total payroll rather than by number of employees. As shown in Figure 1b, 87 percent of firms had an annual payroll of less than $500,000 in 2006, and these firms accounted for 19 percent of private sector employment. The figure also lists the corresponding shares for firms with payrolls of less than $250,000 and less than $1 million.[2]

Figure 1b: Share of Total Firms and Total Employment by Size of Payroll, 2006



Source: U.S. Census Bureau. 2006 County Business Patterns.

[2] U.S. Census Bureau (2008).

In addition to being a substantial source of existing jobs, small businesses account for a disproportionate share of employment growth. Firms with fewer than 20 employees accounted for 25 percent of net employment growth from 1992 to 2005.[3] Comparing this with their average share of all private sector employment during this same period (which was 19 percent), the rate of net job creation per worker in firms with fewer than 20 employees was 40 percent greater than the corresponding rate for all other firms.[4]

Furthermore, the vast majority of new firms, which are a critical source of innovation and growth in our economy, begin as small businesses. Indeed, despite their size, these small businesses account for a substantial majority of jobs in start-ups.[5]

Table 1: Firms' Employment Share By Industry in 2006

Industry	**Firm Size**	
	Fewer than 20 employees	***More than 20 employees***
Construction	12%	5%
Manufacturing	5%	13%
Wholesale Trade	6%	5%
Retail Trade	13%	13%
Finance and Insurance	4%	6%
Professional, Scientific, and Technical Services	11%	6%
Administrative and Support and Waste Management and Remediation Services	5%	9%
Health Care and Social Assistance	12%	14%
Accommodation and Food Services	10%	9%
Other Services	12%	3%
All Other Industries	11%	17%

Source: U.S. Census Bureau. 2006 County Business Patterns.
Note: Employment share by industry is the percent of total employees for a given firm size in each industry. These data exclude government employment. Due to rounding, employment shares may not add to 100 percent.

[3] U.S. Department of Labor (2005b).
[4] Small firms accounted for 24.6 percent of net employment growth from 1992 to 2005 (U.S. Department of Labor, 2005a) and an average of 18.9 percent of employment during that same period (U.S. Small Business Administration, 2009b). Taking the ratio of these to calculate net employment growth per worker and dividing it by the corresponding ratio for firms with 20 or more employees yields a value of 1.40.
[5] Haltiwanger, Jarmin, and Miranda (2008).

Table 1 compares the industrial composition of businesses by size, and illustrates that small businesses have a significant presence in a wide variety of industries. Not surprisingly, small businesses are somewhat disproportionately located in service industries. They are, however, widely distributed within the service sector – ranging from accommodations and food services to professional, scientific, and technical services. Small businesses also tend to be disproportionately located in construction: 12 percent of small firm employment is in construction, compared with only 5 percent of firms with 20 or more workers. The strong presence of small firms throughout all industries reinforces the importance of crafting health care reform that supports the unique needs of the small business community.

III. The Effects of the Current Health Insurance System on Small Businesses

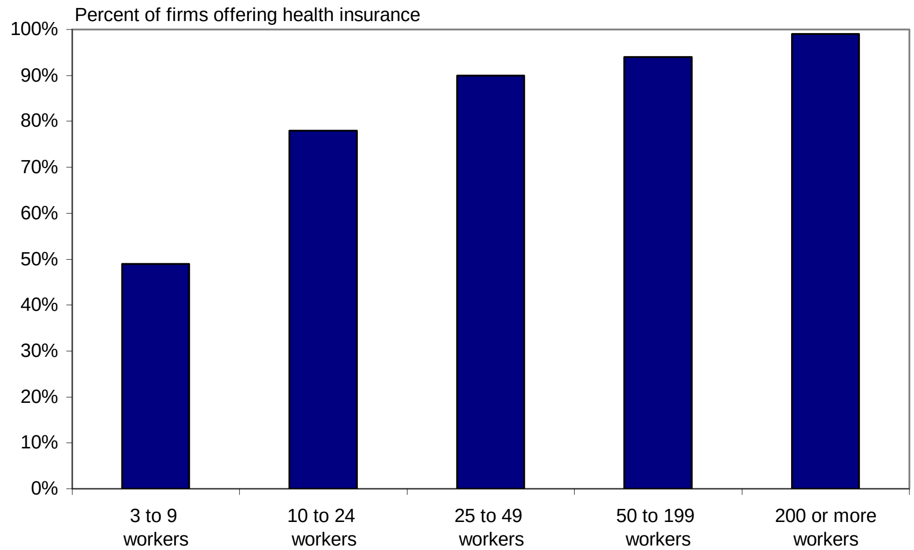
The current U.S. health care system is not working well for small businesses. Most obviously, small businesses pay substantially more to provide insurance for their workers. On average, small businesses pay up to 18 percent more than large firms for the same health insurance policy.[6] There are three primary reasons for this difference. First, small businesses generally pay high broker fees for their policies; these fees typically range from 2 to 8 percent of premiums, and in some cases may be up to 10 percent. Such commissions are on average greater than those paid by larger employers.[7] Second, the fixed costs to a private insurer of setting up and administering a firm's health insurance policy can be spread over many more employees in large firms, and thus administrative costs per covered individual are up to three times higher for small firms.[8] Finally, small firms pay an additional amount per covered individual because of the phenomenon of "adverse selection." Private insurers know that, among small firms, those with workers who have high health care needs are more likely to seek insurance, which raises rates for other small businesses and prices many firms out of the market.[9]

Largely due to the higher costs they face, small businesses are far less likely than large businesses to provide health insurance for their workers. Figure 2 shows the fraction of firms providing health insurance by firm size. Just 49 percent of firms with 3 to 9 workers and 78 percent of firms with 10 to 24 workers offered health insurance to their employees in 2008, compared with 99 percent of firms with 200 or more employees in the same year. Approximately half of firms with fewer than 200 employees not offering health insurance cite high premiums as the most important reason for not doing so.[10]

The fraction of small firms offering health insurance to their employees has also been declining in recent years. From 2002 to 2008, the fraction of firms with 3 to 9 workers offering health insurance declined from 58 percent to 49 percent.[11]

[6] Gabel et al. (2006).
[7] Conwell (2002).
[8] Congressional Budget Office (2007).
[9] See Congressional Budget Office (2009a) and Simon (2005).
[10] Kaiser Family Foundation and Health Research and Educational Trust (2008).
[11] Kaiser Family Foundation and Health Research and Educational Trust (2008).

Figure 2: Employer Health Insurance Offer Rates by Size of Firm, 2008



Source: Kaiser Family Foundation and Health Research and Educational Trust. "Employer Health Benefits: 2008 Annual Survey."

Health insurance offer rates also vary substantially with the average wages of employees. For example, among establishments with 10 to 24 employees in 2006, 76 percent of those paying an average hourly wage over $10.50 offered health insurance, versus just 34 percent of those paying an average hourly wage below $10.50.[12]

Because offer rates are so much lower at small firms, workers in small firms are significantly more likely to be uninsured than their counterparts at larger firms. Specifically, 29 percent of non-elderly adult workers in firms with fewer than 25 employees were uninsured in 2007, versus just 10 percent of non-elderly adult workers in firms with 500 or more employees.[13]

For those small firms that do offer coverage, the generosity of coverage is much lower than in large firms. As Figure 3 shows, workers in small firms have higher deductibles than workers at large firms, and the difference has been growing over time. Workers in small firms are also less likely to have a choice of plan and tend to have less generous coverage for numerous services.[14] This difference in plan generosity is the predictable response to the higher price that small firms must pay for any given level of coverage.[15]

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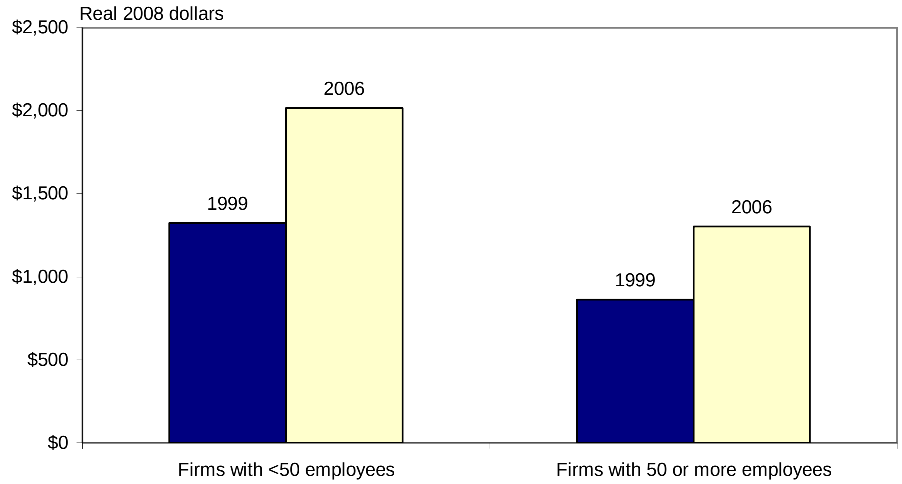
[12] U.S. Department of Health and Human Services (2009a). It is worth noting that these data use the establishment rather than the firm as the unit of analysis. According to the Bureau of Labor Statistics, more than 95 percent of firms have just one establishment. However, multi-establishment firms account for a much larger share of employment (55 percent), as they have more employees on average. See U.S. Department of Labor (2005a).

[13] The calculation is based on the March 2008 Current Population Survey, U.S. Department of Commerce (2008). Further, many small business employees receive health insurance as spouses or dependents of individuals in their households who work at large firms. This suggests that the fraction of small-firm employees receiving insurance would be much lower if it were not for this practice of "implicit pooling." See Monheit and Vistnes (1994).

[14] Kaiser Family Foundation and Health Research and Educational Trust (2008).

[15] For more on the burden health insurance imposes on small firms, see Eibner (2008).

Figure 3: Average Employer-Sponsored Health Insurance Family Deductibles by Firm Size, 1999 and 2006



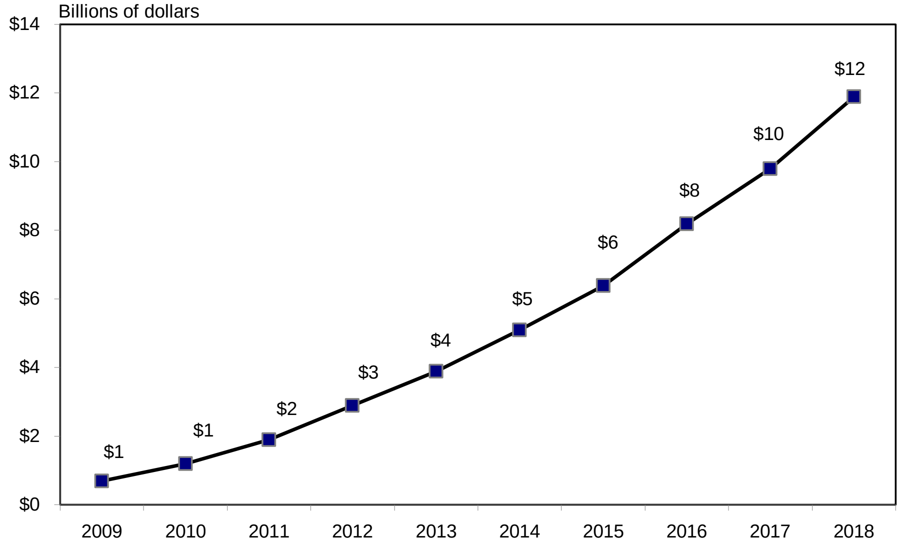
Source: Agency for Healthcare Research and Quality. Medical Expenditure Panel Survey Insurance Component (MEPS IC): 1999 & 2006.
Note: Estimates are restricted to plans that have a deductible provision.

Put simply, the current U.S. health care system imposes a heavy tax on small businesses and their employees. Those small firms that do offer coverage have to pay a higher cost than their larger competitors. To the degree that higher costs are passed on to workers, small firms pay lower take-home wages to their employees. Those small firms that do not offer coverage have employees who do not receive the substantial tax benefits of employer-provided health insurance that their counterparts at large firms enjoy. These employees are more likely to purchase policies in the individual market, where they pay much higher rates. In either case, small firms are likely to be at a competitive disadvantage in the market for hiring workers. Small firms are likely to have a more difficult time than larger firms recruiting potential employees who do not have health insurance from another source. Even if a small firm provides the best fit for a worker's skills and interests, the individual may choose not to work there given the implicit tax.

To the degree that small firms providing health insurance cannot pass on the costs to workers, the firms will earn lower profits and be at a competitive disadvantage relative to large firms in the markets for their products. A recent study by the Small Business Majority concludes that small business profits will shrink over time because of rising health care costs that firms cannot fully pass on to workers. Figure 4 reproduces the study's estimates of small business profits lost per year due to rising health care costs without reform.[16] In light of these findings, it is perhaps not surprising that recent surveys of small business owners have found widespread support for health care reform that reduces health care costs.[17]

[16] Small Business Majority (2009a).
[17] Robert Wood Johnson Foundation (2008).

Figure 4: Annual Small Business Profits Lost Due to Healthcare Costs



Source: Small Business Majority. "The Economic Impact of Healthcare Reform on Small Business." June 2009.

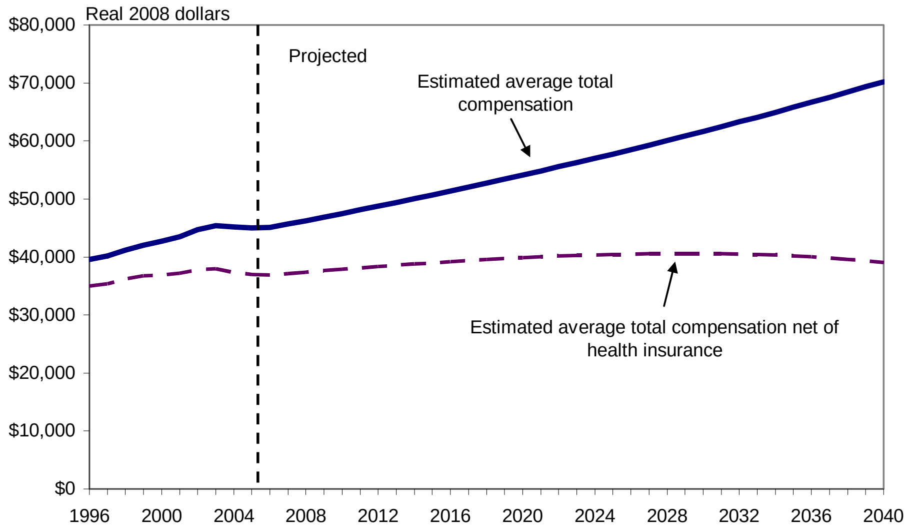
IV. The Overall Economic Benefits of Health Care Reform

At the most fundamental level, health care reform will benefit small businesses and their employees in the same way that it helps all American firms and households. By slowing the growth rate of costs and expanding coverage, it will raise living standards, spur economic growth, help tame the budget deficit, and improve the efficiency of the labor market. These effects will be felt throughout the economy and will help all businesses thrive. Therefore, before detailing the ways that reform will particularly ease the burden on small businesses, it is useful to summarize the overall economic benefits of reform.

In a report issued in June 2009, the CEA provided projections of health care expenditures, insurance premiums, and other key variables if current trends in the health care sector continue.[18] In the absence of reform, we found that health care expenditures would likely rise from their current level of 18 percent of GDP to 28 percent in 2030 and 34 percent in 2040. For families, this trend would show up in steeply rising insurance premiums and stagnating take-home wages. Figure 5 shows our projections of total compensation and compensation net of health insurance. Without reform, essentially all of the rise in average compensation due to increasing productivity over time would go to health insurance, and essentially none would go to take-home wages. For the government, rising health care costs would show up in steeply rising Medicare and Medicaid spending and unsustainable increases in the budget deficit. Finally, we projected that the number of uninsured people in the United States would rise from 46 million in 2007 to 72 million in 2040.

[18] Council of Economic Advisers (2009).

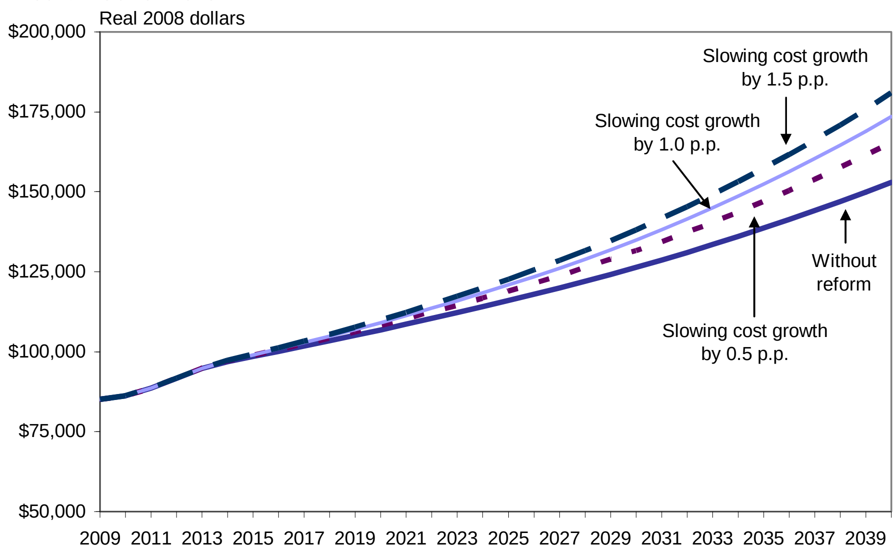
Figure 5: Projected Annual Total Compensation and Compensation Net of Health Insurance



Source: CEA calculations.

The CEA report showed that successful reform that genuinely slows the growth rate of health care costs would have tremendous benefits for American workers, businesses, and the government. Figure 6 shows our estimates of the impact of slowing the annual growth rate of health care costs by different amounts on median income for a typical family of four over time.

Figure 6: Estimated Family Income with and without Health Care Reform

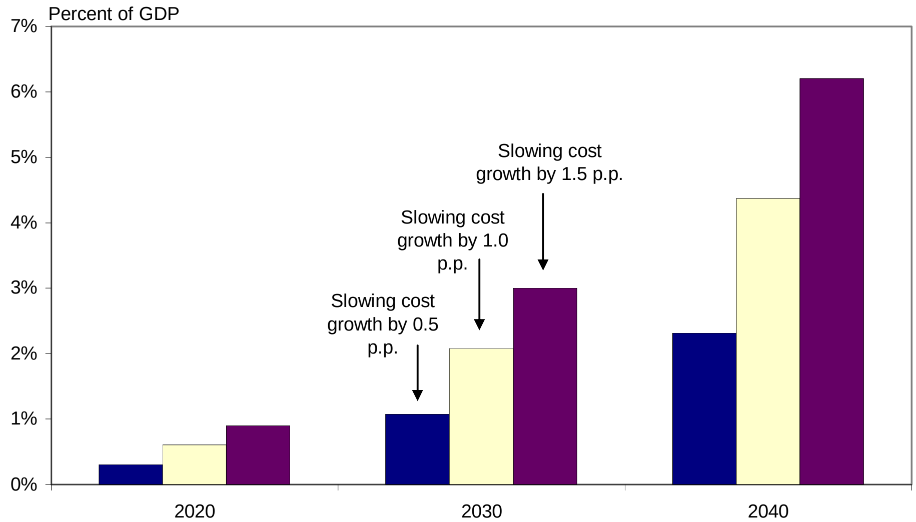


Source: CEA calculations.

We found that reducing the growth rate of health care costs by 1.5 percentage points per year would raise family income relative to what it otherwise would have been by nearly $2,600 in 2020 and by almost $10,000 in 2030.

Figure 7 shows our estimates of the effects of slowing the growth rate of health care costs on the budget deficit. Reducing the growth rate of costs by 1.5 percentage points per year would reduce the government budget deficit relative to what it otherwise would have been by roughly 3 percent of GDP in 2030 and 6 percent of GDP in 2040. Lower budget deficits are obviously important for the long-run health and stability of the economy. They are also important for keeping interest rates low for American families and businesses.

Figure 7: Reduction in the Federal Budget Deficit Due to Health Care Reform



Source: CEA calculations.

Draft legislation has been released both by the three House Committees with jurisdiction over health care and by the Senate Health, Education, Labor, and Pensions (HELP) Committee.[19] The Senate Finance Committee is also expected to release a draft proposal shortly. The available House and Senate drafts contain several features designed to slow the growth rate of costs. For example, the House legislation contains provisions encouraging the use of innovative payment structures, such as bundling payments for episodes of care and incentives to reduce preventable hospital readmissions. Both the House and the Senate also include increased emphasis on research into what procedures genuinely work for patients. President Obama has recommended a number of other delivery system reforms that would affect the growth of health care spending over time, which are included in reform proposals emerging in Congress. He has also strongly supported proposals to provide greater certainty around implementation of the recommendations of the Medicare Payment Advisory Commission.[20]

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[19] See U.S. Congress, House of Representatives (2009) and U.S. Congress, Senate (2009).
[20] Obama (2009).

The CEA report detailed the ways in which coverage expansion is likely to have important economic benefits.[21] We showed that expanding coverage to the millions of uninsured Americans would have dramatic effects on economic well-being. Our estimates suggest that the benefits from improved health and the reduced risk of financial disaster would be at least $180 billion per year. Even after accounting for the costs of such coverage, the net benefits are very large. The report also found that improved access to health care would likely have positive effects on labor supply by reducing the prevalence of disability and improving workplace productivity.

Reform proposals under review in Congress would substantially increase health insurance coverage by setting up an insurance exchange through which uninsured people could purchase coverage, without limitations based on pre-existing conditions. The proposals include substantial subsidies for low-income families and expanded eligibility for Medicaid for very low-income individuals. Coverage expansions would also reduce the "hidden tax" that results from uncompensated care of uninsured individuals by hospitals and other health care providers, a cost that is currently passed on to the insured population in the form of higher premiums.[22]

V. The Benefits of Health Care Reform for Small Businesses and Their Employees

In addition to these and many other important benefits of health care reform to individuals, firms, and the government, the House and Senate legislation contain a number of features that are designed to reduce the burdens that the current system places on small businesses and their employees.

A. Lower Premiums and Higher Quality Health Insurance Coverage in the Exchange

As discussed above, small businesses typically pay more than large firms for their workers' health insurance coverage. In the current draft versions of the House and Senate legislation, certain small businesses would be able to purchase health insurance through an insurance exchange. This exchange would allow these businesses to choose from qualified insurance plans offered in their geographic area and would provide transparent data on premiums and services covered by each plan.

The insurance exchange will give small businesses that opt to participate a choice among multiple health insurance plans at lower prices than they can currently find in the small group market.[23] The competition created by the exchange is especially important given recent increases in the concentration of the small group health insurance market.[24] Health insurers in the exchange would not be allowed to exclude individuals on the basis of pre-existing conditions or to vary premiums without limit based on age. Premiums would be lower because of the increase in plan volume and because of reductions in broker fees and underwriting costs. Lower premiums should result in greater competitiveness for small firms.

[21] Council of Economic Advisers (2009).
[22] Families USA (2009).
[23] Small Business Majority (2009b).
[24] U.S. Government Accountability Office (2009).

B. Tax Credits for Small Businesses that Provide Health Insurance

Each of the current draft bills provides significant tax credits to small firms that either continue to provide health insurance to their employees or begin doing so for the first time. For example, the House Tri-Committee bill would allow firms with fewer than 25 employees and with an average annual wage of less than $40,000 to receive a credit. The magnitude of the credit would be greatest for firms with fewer than 10 employees whose average annual wage is less than $20,000, with the credit equal to half of the firm's contribution for health insurance in this case. Thus a firm with 8 employees that paid $20,000 per worker in wages and $8,000 per worker in health insurance premiums would receive a tax credit of $32,000. Firms with 10 to 19 employees with average annual wages between $20,000 and $40,000 would also receive a tax credit. The Senate HELP Committee bill would provide a comparable credit to an even larger number of small businesses, with firms employing fewer than 50 workers and with an average annual wage of less than $50,000 eligible for a credit.

To gauge the potential importance of the small business tax credit, it is useful to consider the amount that the Congressional Budget Office (CBO) estimates will be spent on it during the 2010 to 2019 period. According to CBO's estimates on July 17, 2009 of the House Tri-Committee draft, small businesses will receive $53 billion in tax credits during this period.[25] These additional funds will allow small business owners, who typically pay higher interest rates for loans than their larger competitors, to invest in their businesses and eventually create more jobs.[26] This credit, like lower insurance premiums, should result in lower costs and thus in both higher wages for workers and larger profits for firms.

C. Exemption from Employer Responsibility Requirements

Both the House and the Senate bills would give medium and large firms a financial incentive to provide health insurance coverage to their employees through pay-or-play provisions. These would serve to reduce the financial incentive that some firms have to stop providing employer-sponsored health insurance. However, firms with payrolls or employment levels below a certain threshold would be exempt from these employer responsibility requirements. The proposed thresholds would exempt the vast majority of small firms.

D. Subsidies for Employees in Small Businesses that Do Not Provide Health Insurance

The exchange will also provide better options for workers in small businesses that do not offer insurance. The current individual private insurance market is characterized by high prices and restrictive rules that hurt workers with pre-existing conditions.[27] Under the legislation currently being considered, individuals or families could take advantage of improved health choices through the exchange. Furthermore, individuals and families with incomes of less than 400 percent of the poverty line would receive sliding-scale subsidies to purchase insurance. For example, under the House bill, a worker with a spouse and two children whose family income is $40,000 per year would pay approximately $1,700 for a policy that in the non-group market would cost $12,000 or more. That family would also be shielded from very high co-pays or deductibles, with an out-of-pocket maximum of $850 or less.

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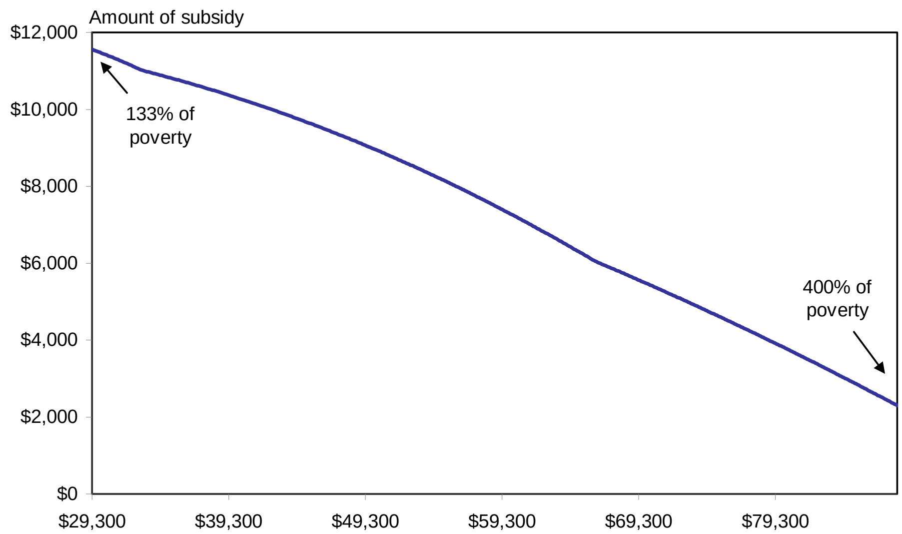
[25] Congressional Budget Office (2009b).
[26] See Degryse and Van Cayseele (2000) for discussion of small firm and large firm interest rates.
[27] Kaiser Family Foundation (2008).

The health insurance subsidy that a family of four would receive as a function of income is displayed in Figure 8. This figure assumes that in the absence of the policy, the premium for the family would be $12,000 per year, and uses the 2009 value of $22,050 for the poverty line for a family of four.[28] Individuals in families with incomes of less than 133 percent of the poverty line would be eligible for health insurance through Medicaid.

Figure 8: Premium Subsidy for $12,000 Family Health Insurance Policy by Income



Source: CEA calculations, based on draft House legislation.

This figure shows that subsidies for health insurance premiums would be substantial for low- and middle-income workers. The subsidy declines as income rises, though it does not completely phase out until workers reach a family income of $88,200.[29] The subsidies under the Senate bill are structured somewhat differently from those in the House bill, but are similar in size and scope. To the extent that workers in small businesses will be more likely than their counterparts at large firms to purchase insurance through the exchange, they will differentially benefit from these subsidies.

An examination of data from the March 2008 Current Population Survey indicates that 52 percent of non-elderly adult workers in firms with fewer than 25 workers who are without health insurance would be eligible for subsidies for purchasing health insurance in the exchange as specified in both the House and Senate legislation. An additional 26 percent (with incomes below 133 percent of the poverty line) would be eligible for health insurance through the Medicaid program.[30] More generally, because workers at small firms are significantly more

[28] U.S. Department of Health and Human Services (2009b).
[29] The House bill covers individuals and families with incomes up to 400 percent of the poverty line. (The poverty line is indexed to grow with inflation.)
[30] Based on data from the March 2008 Current Population Survey. The survey breaks income as a percent of the poverty level into groups; for example, income from 125 percent to 149 percent of the poverty level is one group. The numbers in the text assume that one-third of the families in this group have incomes below 133 percent of the poverty level, and the remaining two-thirds have incomes above 133 percent of the poverty level.

likely to be without health insurance than other workers, health care reform that expands health insurance coverage, increases the number of plan options, and reduces premiums will be particularly important for employees of small firms.

E. Increasing Entrepreneurship, Expanding the Pool of Workers Available to Small Businesses, and Eliminating "Job Lock"

The high prices of health insurance in the non-group and small group markets and the possibility that a pre-existing condition will prevent a worker from obtaining coverage at any price distort individuals' career choices. Both factors discourage individuals from launching their own companies, and make many individuals unwilling to work for small businesses. Limitations on pre-existing conditions create the phenomenon of "job lock," causing many workers to remain in their jobs at large firms even if they would be more productive and better paid at a small business.[31]

Consistent with this, individuals who are above the age of 65, and thus can obtain health insurance through Medicare, are substantially more likely to work for small firms than are their counterparts who are just below the age of 65. Table 2 lists the share of workers in the 60 to 64 and 65 to 69 age ranges working for firms in one of three different size ranges.

Table 2: Share of Workers in Different Age Groups by Firm Size

Size of Firm	Ages 60-64	Ages 65-69
1-24 workers	33%	41%
25-499 workers	25%	23%
500+ workers	42%	36%

Source: Current Population Survey, March 2008.

Among workers between the ages of 60 and 64, 33 percent work in firms with fewer than 25 employees. At 41 percent, the corresponding share among workers between the ages of 65 and 69 is substantially greater. This difference strongly suggests that the greater availability of health insurance from Medicare encourages more elderly workers to join small firms, and thus that reform-induced expansions in health insurance coverage will increase the pool of available workers for small businesses.

By reducing the prices of health insurance for individuals and small groups, and preventing insurers from excluding those with pre-existing conditions, health care reform as described both in the House and in the Senate bills would remedy these distortions. As a result, entrepreneurial activity would likely increase, individuals who would not otherwise work for small firms will have increased incentives to do so, and individuals will be more likely to move to jobs that provide better matches to their skills and needs.

[31] The CEA estimated that the economic costs of job lock were approximately 0.2 percent of GDP per year (Council of Economic Advisers, 2009). See also Gruber (2000), Monheit and Cooper (1994), and Madrian (2007).

F. Improvements in Workplace Productivity and Reduced Absenteeism

Expanding health insurance coverage, both by encouraging firms to provide insurance and by creating a well functioning insurance exchange, is likely to improve the health of newly covered workers. This improvement has obvious benefits for the workers. But, it may also be beneficial to firms because it will reduce absenteeism and perhaps increase productivity. These effects are likely to be particularly large for small firms for two reasons. First, because they have a smaller pool of workers from which to draw when an employee is out of the office or not working at full capacity for health reasons, small firms are more vulnerable than large firms to health-induced changes in worker absenteeism and productivity.[32] Second, as described above, workers at small firms are particularly likely to gain coverage because of health care reform.

VI. Conclusion

Health care reform as envisioned by the President and in the current draft legislation in both chambers of Congress will greatly reduce the burdens that the current system places on small businesses. This is especially important given the key role that small firms play in job creation and innovation.

Rising costs of health care and high levels of uninsurance have had – and if they are not addressed will continue to have – a severe impact on our overall economy, standards of living, and the government budget deficit. Moreover, the current system places a disproportionate burden on small businesses and their workers. Small firms face higher costs of employer-sponsored insurance and, as a result, are at a competitive disadvantage relative to large firms in both their product markets and in the market for hiring the best workers.

Successful health care reform that genuinely slows the growth rate of costs will greatly aid the overall economy in general and small businesses in particular. Controlling costs will cause living standards and take-home wages to rise more quickly for American workers. Reform will lead to increases in entrepreneurial activity and to a more efficient allocation of workers throughout the economy. And by reducing future federal budget deficits relative to what they otherwise would have been, health care reform will serve to lower the cost of capital and reduce future tax increases for small businesses, which will lead to more investment and job creation in this key component of the economy.

Perhaps most important of all, health care reform will improve both the health and the economic well-being of small business employees through the expansions in health insurance coverage and reductions in health care costs. Employees of small businesses and their families are significantly more likely to be without health insurance than their counterparts at larger firms. The reform-induced expansions in health insurance coverage will lead to improvements in the health of these workers and their families and will reduce their exposure to the risk of medical bankruptcy. It will also allow them to enjoy the fruits of their productivity growth in the form of higher wages rather than spending those funds on ever-increasing health insurance premiums.

[32] Pauly et al. (2002).

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