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Disincentive Effects of the PPACA on Job Creation

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Chairman Herger, members of the Committee, I am honored to be invited to testify before you today on the effects of the Patient Protection and Affordable Care Act on the franchise industry. The Act has employment effects on millions of Americans, and I thank you for holding this hearing.

I am a senior fellow at the Manhattan Institute. From 2005 through September 2011 I was a senior fellow at the Hudson Institute, where I authored a study entitled *The Effects of the Patient Protection and Affordable Care Act on the Franchise Industry*. From 2003 until April 2005 I was chief economist at the U.S. Department of Labor. From 2001 until 2002 I served at the Council of Economic Advisers as chief of staff. I have served as Deputy Executive Secretary of the Domestic Policy Council under President George H.W. Bush and as an economist on the staff of President Reagan's Council of Economic Advisers.

High unemployment rates are at the top of the list of concerns for American workers. In early March, the Labor Department announced that the unemployment rate held steady at 8.3 percent. The rate has remained above 8 percent for over three years.

Even though an 8.3 percent rate of unemployment is high, it masks a broader employment problem in the workforce. Including discouraged and underemployed workers, the Labor Department's measure of unemployment is 14.9 percent. And many workers have left the labor force because they have not been able to find jobs. The labor force participation rate has declined from 66 percent in January 2009 to 63.9 percent today—a rate that is about equal to the early 1980s.

Could it be that the $2,000 per worker penalty in the new health care law, effective 2014 and levied on employers who do not provide the right kind of health insurance, is discouraging hiring?

The Patient Protection and Affordable Care Act of 2010 will raise the cost of employment when fully implemented in 2014. Companies with 50 or more workers will be required to offer a generous health insurance package, with no lifetime caps and no copayments for routine visits, or pay an annual penalty of $2,000 for each full-time worker.

This penalty raises significantly the cost of employing full-time workers, especially low-skill workers, because the penalty is a higher proportion of their compensation than for high-skill workers, and employers cannot take the penalty out of employee compensation packages.

Employers are not blind. They see these penalties coming, and they are adjusting their workforce accordingly.

The evidence that employers are economizing on workers is all around us. More supermarkets and drug stores have self-scanning machines at checkout. Large

department stores have price-scanning machines scattered around the stores, so that shoppers can check prices without asking a clerk. Food trucks line the streets in New York and Washington, D.C., enabling restaurants to sell their food without waiters. These workforce adjustments are just one reason that employment growth has been slower than usual during this economic "recovery."

Hardest hit are workers with fewer jobs skills. The unemployment rate for adult workers with less than a high school diploma is 12.9 percent. Teens face an unemployment rate of 23.8 percent. The rate for African American teens is even higher, at 34.7 percent.

Another group that is disproportionately affected is younger workers. Of the 2 million adults who found jobs over the past year, 1.7 million are over 55 years old, and 300,000 are between 25 and 55—even though the 25 to 55 group is three times the size of those 55 and older. Younger workers have far fewer employment opportunities, which affects their lifetime expected earnings.

Suppose that a firm with 49 employees does not provide health benefits. Hiring one more worker will trigger an annual penalty of $2,000 per worker multiplied by the entire workforce, after subtracting the statutory exemption for the first 30 workers. In this case the penalty would be $40,000, or $2,000 times 20 (50 minus 30). Indeed, a firm in this situation might have a strong incentive not to hire a 50th worker, or to pay him off the books, thereby violating the law.

In addition, if an employer offers insurance, but an employee qualifies for subsidies under the new health care exchanges because the insurance premium exceeds 9.5 percent of his income, his employer must pay $3,000 per worker. This combination of penalties gives businesses a powerful incentive to downsize, replace full-time employees with part-timers, and contract out work to other firms or individuals. For example, a restaurant might outsource some of its food preparation versus paying employees to make it on-site.

What has been rarely discussed is that the franchise industry will be particularly hard-hit because the new law will make it harder for small businesses with 50 or more employees to compete with those with fewer than 50 employees.

Franchisors and franchisees, who often own groups of small businesses, such as stores, restaurants, hotels, and service businesses, will be at a comparative disadvantage relative to other businesses with fewer locations and fewer employees. This will occur when a franchisor or franchisee employs 50 or more persons at several locations and finds itself competing against independent establishments with fewer than 50.

An estimated 828,000 franchise establishments in the U.S. accounted for more than $468 billion of GDP and more than 9 million jobs, based on PricewaterhouseCoopers' report

of 2007 Census data.[1] When factoring the indirect effects, these franchise businesses accounted for more than $1.2 trillion of GDP—or nearly 10 percent of total non-farm GDP. Of franchise businesses, an estimated 77 percent were franchisee-owned and 23 percent were franchisor-owned.

Franchise businesses can be organized in many ways. In some cases the franchisor, or parent company, will own and operate some locations while franchising others. In other cases, a franchisee will own a single location or "unit." In a third set of cases, a franchisee will own multiple locations, referred to as a "multi-unit franchisee." More than half of all franchise establishments are owned by multi-unit franchisees. In the cases where the franchisor and the franchisee own and operate multiple locations, these firms are treated as one company for penalty and health care purposes.

The new health care law would put many franchise businesses at a disadvantage relative to non-franchise competitors by driving up their operating costs. Many of these businesses would be subject to the $2,000 health care penalty if they do not provide health insurance. The multi-unit franchisees will have a particularly difficult time operating in this uneven business environment.

Suppose a multi-unit franchisee owns four establishments with 15 full-time employees each. Under the new health care law, this multi-unit franchisee will be treated as a single firm with 60 full-time employees, and the employer will be required by law to provide healthcare benefits for all employees or pay a fine of $2,000 per full-time employee per year.

However, if these four establishments were owned and operated separately, they would be exempt from the requirement of providing healthcare benefits. Further, if these four separately-owned businesses choose to offer health insurance, they would in some cases be entitled to a penalty credit.

When the employer mandates are phased in 2014, many franchise businesses will be motivated to reduce the number of locations and move workers from full-time to part-time status. This will reduce employment still further and curtail the country's economic growth. More than 3.2 million full-time employees in franchise businesses may be affected.

Industries that have traditionally offered the greatest opportunities to entry-level workers—leisure and hospitality, restaurant—will be particularly hard-hit by the new law. Many of these employers do not now offer health insurance to all of their employees, and employ large percentages of entry-level workers, whose cost of hiring will increase significantly.

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[1] PricewaterhouseCoopers (PwC), February 2011 (b), The Economic Impact of Franchised Businesses: Volume III, Results for 2007, February 2011.

The franchise industry has offered an entry point to low-skill workers, who have some of the highest unemployment rates in America. Adults without high school diplomas face an unemployment rate of 12.9 percent, more than 3 times as high as rates for college graduates, and well above the national average of 8.3 percent.

Under the new law, for each block of 30 weekly hours of part-time work by one or more employees a business is deemed to have one full time equivalent employee. The penalty for full-time employees is $2,000 per worker after the first 30 employees.

Businesses with fewer than 50 employees will have an advantage. If they do not hire too many workers - another government-induced disincentive for hiring in this weak labor market - and stay within the 49-person limit, these firms will not have to provide health insurance and will have a cost advantage over the others. Such businesses will be able to compete advantageously against businesses with multiple locations and 50 or more employees.

The $2,000 penalty will amount to 12 percent of average annual earnings in the food and beverage industry and 8 percent in retail trade. This is a cost in addition to the employer's share of Social Security and Medicare taxes (7.65 percent, equal to what the employee pays), as well as workers' compensation and unemployment insurance.

When the government requires firms to offer benefits, employers will generally prefer to hire part-time workers, who will not be subject to the penalty. Even though the Act counts part-time workers by aggregating their hours to determine the size of a firm, part-time workers are not subject to the $2,000 penalty. Hence, there will be fewer opportunities open for full-time work. Many workers who prefer to work full-time will have an even harder time finding jobs.

In August 8.8 million people were working part-time because they could not find full-time jobs. The new health care law would exacerbate this problem.

In addition to hiring more part-time workers, firms will have an added incentive to become more automated, or machinery-intensive—and employ fewer workers. Fast food restaurants could ship in more precooked food and reheat it, rather than cook it on the premises. Something analogous is already gaining momentum in industries such as DVD rental, where manual labor at retail outlets is being replaced by customer-activated DVD checkout. Supermarkets, drugstores and large-chain hardware stores also are introducing do-it-yourself customer checkout.

Some employers will be allowed to keep existing plans, a term known as "grandfathering." However, restrictions on "grandfathering" could force up to 80 percent of small businesses to drop their current health insurance plans within three

years and either replace them with more expensive new plans or go without insurance altogether and pay the penalty, according to the government estimates.[2]

The restaurant industry, which represents 23 percent of franchise businesses by number and 50 percent of franchise business employment, provides an example of how firms with seasonal, part-time employees, competitive environments, and low profit margins will face new challenges in connection with the provision of health insurance. Some restaurant owners are likely to drop existing coverage that no longer meets the requirements of the Act. Several restaurants received waivers from the Department of Health and Human Services in 2011, but these waivers will not continue into 2014, once the Act is fully phased in. Many restaurants will be penalized because their low-wage workers will choose to get subsidized coverage on the state exchanges.

The disincentive in the Act to hire additional workers is illustrated in Table 1. If a business does not offer health insurance, then, beginning 2014, it will be subject to a penalty if it employs more than 49 workers in all its establishments. For 49 workers, the penalty is 0. For 50 workers, the penalty is $40,000; for 75 workers, it is $90,000; and for 150 workers, the penalty is $240,000. Each time a business adds another employee, the penalty rises.

On the other hand, as is shown in Table 2, businesses can reduce costs by hiring part-time workers instead of full-time workers. A firm with 85,000 full-time workers and 7,000 part-time workers that does not offer health insurance would pay a penalty of $170 million. By keeping the number of hours worked the same, and gradually reducing full-time workers and increasing part-time workers, until the firm reaches 17,000 full-time workers and 92,000 part-time workers, the penalty is reduced to $34 million. If the firm abandons full-time workers altogether, admittedly an unlikely option, but useful for illustration, the penalty is reduced to zero.

Some businesses, single-unit franchisees and others, could minimize cost by increasing part-time hourly workers, reducing the number of full-time workers, and dropping employer-provided health insurance. Even if businesses choose to offer health insurance to their full-time employees, the Act gives them an incentive to employ more part-time hourly workers than full-time workers in an effort to maximize penalty benefits. If Congress leaves these incentives in place, the reduction in full-time employment would be costly to the economy.

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[2] U.S. Department of the Treasury, U.S. Department of Labor, U.S. Department of Health and Human Services, "Interim Final Rules for Group Health Plans and Health Insurance Coverage Relating to Status as a Grandfathered Health Plan Under the Patient Protection and Affordable Care Act," *Federal Register*, Vol. 75, No. 116, Thursday, June 17, 2010.

Table 3, with data taken from the International Franchise Association Educational Foundation, shows the costs of the new health care law to the multi-unit franchise business. Multi-unit franchisees would face more than $3.5 billion in penalties—penalties that could be reduced if firms switched from full-time to part-time workers. Costs would be highest in the quick service restaurant industry, with total penalties of more than $1.6 billion. More than 1.7 million full-time jobs are at risk in multi-unit franchisee businesses, with 820,000 jobs in the quick service industry.

With employment growth slowing and unemployment high, it is worth examining the effects of penalties on employment under the new health care law. America cannot afford these negative effects on employment.

Thanks for inviting me to testify today. I would be glad to answer any questions.