Health Care Reform and Small Business

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Summary

An issue in the development of the new health care reform legislation is the effect on small business. One concern is the effect of a "pay or play" mandate to require firms to provide health insurance for their employees or pay a penalty. Current proposals have exemptions for small businesses, and also propose to provide subsidies for purchasing insurance. Economic theory suggests that health insurance costs (and any penalties) should be passed on to labor income, but that may be more difficult for employers of lower-wage workers. Furthermore, average wages are generally smaller for small firms (except for the smallest). A second concern is the potential effect of taxes on high-income individuals on small business.

Both the House bill (H.R. 3962, passed on November 14, 2009) and the Senate bill (H.R. 3590, passed on December 24, 2009) would exempt small businesses from penalties. On March 22, 2010, the House passed the Senate bill (H.R. 3590) and the President signed it on March 23, 2010 (P.L. 111-148). The House bill would have applied no penalties to firms with $500,000 or less in payroll; the Senate bill exempts firms with 50 or fewer employees. While both proposals would exempt most firms, the Senate bill would exempt more, probably around 95%, and the share of firms that would not be affected either because they are exempt or because they already offer insurance would be larger, probably around 98%. About 20% of employees work for firms that were estimated to be affected.

Along with adopting the Senate proposal, the House passed a separate measure, H.R. 4872, which would alter the penalties and revenue sources in H.R. 3590; it was adopted with some modifications on March 25, and signed by the President on March 30 (P.L. 111-152). The penalties in the original Senate bill were per-employee flat dollar amounts of $750 a year for firms that do not offer coverage, triggered if one or more employees are eligible for the premium credit for lower- income families. They are relatively small compared with the cost of health insurance. The reconciliation proposal would impose a larger penalty of $2,000 per employee, but exempt the first 30 employees. Firms that offer insurance also will pay penalties if their employees enroll in individuals plans and receive the premium credit, only for those employees. The penalties appear smaller than those in the House proposals, which are calculated as a percentage of payroll. The proposals also provide temporary credits to subsidize small employers' contributions to insurance for lower-income employees that depend on firm size and employee compensation. The credits are the same in the two bills (except that the Senate bill allows a higher compensation phaseout), and would be as much as 50% of the employer's cost. The subsidy for taxable firms is provided as a nonrefundable income tax credit and would not benefit firms with no income tax liability; the Senate bill, however, has a separate 35% credit for nonprofits.

The original Senate proposal had increased Medicare taxes on earned income on married couples with incomes over $250,000 and singles with incomes over $200,000 by 0.9 percentage points. H.R. 4872 extends the Medicare tax on high-income individuals to passive investment income by taxing that income at 3.8%. Some concerns had been raised earlier about the effect on small business of a high-income surcharge in the House bill, which would have imposed (for couples) at 5.4% on incomes over $1 million ($500,000 for singles). The surcharge would have affected 0.3% of taxpayers and 1.2% of unincorporated businesses. The Medicare tax on investment affects a larger total share of the population (2.6%) but is imposed at a smaller rate and is not likely to fall on small business owners whose capital is invested in their business because this income is either already subject to Medicare or is exempt.

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Introduction

One issue that has been of interest in the development of the new health care reform legislation is the effect on small business. An important feature of the plans is a "pay or play" mandate to require firms to provide health insurance for their employees or pay a penalty. Given the structure of individual market reforms, the comprehensiveness of a mandate for individuals is important to the success of the reform of health insurance markets. Employer mandates are also included in the proposals. There is a concern that mandates will be damaging to small businesses.

The legislation being considered in both the House and Senate includes exemptions for small businesses, and credits to assist in providing health insurance, but these provisions differ.[1] These provisions have consequences both for small businesses and for the reforms of the individual health insurance market. Another issue that has received attention in the House legislation is the effect of using a surtax on high-income individuals as a financing option.

On March 22, 2010, the House passed the Senate bill (H.R. 3590) and the President signed it on March 23. The House also passed a separate bill that modifies the revenue sources and penalties, H.R. 4872, which is now being considered in the Senate.

This report first provides a brief discussion of the need for mandates in comprehensive health care reform and why employer mandates might be useful. It also describes the provisions in the various proposals, beginning with an overview of the proposal adopted. The next section discusses the potential impact of employer mandates and credits on small business. The final section discusses the effect of proposed taxes on high-income individuals.

The Rationale for Employer Mandates in Health Care Reform

The health insurance and health care markets have some fundamental flaws that economists frequently refer to as "market failures," and many of the provisions in the legislative proposals are aimed at addressing these flaws and market failures.[2] One of these problems is "adverse selection." If individuals know more about their health status than insurance firms, then insurance costs will be too high relative to benefits for healthy individuals, who will tend not to purchase health insurance. Their lack of participation causes the price of insurance to rise further, as those now in the insurance pool are less healthy. The end result is that many individuals will not have health insurance, exposing them to risk in the case of ill health and possibly imposing a burden on society if their illnesses become serious enough to deplete their wealth and require public assistance. In addition, even if both parties are informed about health status, people who have preexisting conditions or other characteristics that make use of health care more likely (such as old age) may not have, or be able to afford, health insurance (assuming that premiums are permitted to reflect such characteristics).

[1] For an overall discussion of these proposals as well as other legislative proposals, see CRS Report R40581, *Health Reform and the 111th Congress*, by Hinda Chaikind.

[2] These "market failures" are discussed in CRS Report RL33759, *Health Care and Markets*, by D. Andrew Austin and in CRS Report RL32237, *Health Insurance: A Primer*, by Bernadette Fernandez.

The problem of adverse selection and excessive cost has been addressed among the elderly by Medicare and is significantly reduced among the working population by employer health insurance. Some states also limit variations in premium costs. Employer health insurance also provides a pooling mechanism that is unrelated to health factors and thus addresses both the adverse selection problem and the problem of being priced out of the market for those with ill health.[3] It also tends to reduce administrative costs compared with such costs when individuals purchase coverage on their own. These pooling and administrative advantages are lessened for businesses with few employees.

Employer-provided health care benefits should, according to economic theory, offset wages so that employees as a group are still incurring the cost of insurance, but do not face the difficulties they would with non-group private insurance purchase. Employers with small pools of individuals may experience some of the same types of problems as individuals. If there is one employee who has (or whose family has) a serious health problem, that problem can drive up the cost for the group. Aside from the problem of too small a pool for small employers, to the extent that small businesses employ lower wage or younger workers, the trade-off of cash wages for health care becomes more difficult, and cannot occur in the case of workers at or close to the minimum wage. As indicated above, the administrative costs per employee are larger in small firms; one study estimates these costs are 18% higher for small businesses.[4] The offering of health care plans is more common in large businesses than small ones, and the participation of workers is generally larger as well.

Two crucial elements are necessary to address the problems relating to adverse selection and lack of affordability, especially for those with preexisting conditions: some form of community pooling so that individuals with health problems (including age) would not have to pay a substantially different price, and a provision to require most individuals to have health insurance. Since health insurance through employers has worked reasonably well and more than 60% of workers are already covered by their employers, a proposal that imposes such mandates on firms might be considered desirable as well.

Small businesses are subject to exemptions from mandates in both the House and Senate proposals. Proposals include temporary credits for certain smaller businesses that have a high-cost employee group and can benefit from the ability to purchase insurance through a program that limits the variation in premiums. House and Senate plans continue to permit existing private individual insurance outside of the community-rated pools. That means that low-cost individuals (the young and healthy) who are not covered by employer plans would wish to retain their plans, thereby raising the costs for those in the community pools. However, the community pools are the only pools that would exist for new coverage and that would provide subsidies, so they are more likely to attract lower-income individuals, even if they are young and healthy and current participation in the individual market is low.

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[3] Employer health insurance also benefits from the exclusion of premium contributions by employers from wage income, which benefits any taxpayers with income tax liability. Insurance benefits are also excluded from the payroll tax although there are future benefits that partially offset the cost of the payroll tax.

[4] Executive Office the President, Council of Economic Advisers, *The Economic Effects of Health Care Reform on Small Businesses and Their Employees*, July 25, 2009.

Overview of Provisions Relating to Small Business Adopted in P.L. 111-148 and P.L. 111-152

This section describes the provisions as included in the law that are especially relevant to small businesses. The penalty structure and the small business credit are described. The final legislation did not include an initial House proposal for a surtax on high-income individuals, which had been an issue of concern with some. That provision did not appear in the Senate proposal and the Medicare tax on high incomes, which is a major revenue raiser, is actually less likely to affect small business income than other income (see discussion in the "Taxes on Incomes of High-Income Individuals" section).

Penalty Structure

Penalties apply for larger firms that do not provide health insurance beginning in 2014. The penalty for not providing insurance is imposed on a monthly basis. Small businesses of less than 50 full-time equivalent employees or less are not subject to the penalty.[5] Solely for purposes of determining the size, part-time employees are aggregated to full-time equivalents by dividing total monthly part-time hours by 120. Seasonal workers are not included in determining employer size if the excess employees were seasonal employees and the workforce did not exceed the limit for more than 120 days during the calendar year.

For a large employer who does not offer insurance and who has at least one employee eligible for premium tax credits or cost sharing reductions in the individual market, a penalty is imposed, The penalty is $2,000 per full-time employee per year (not counting part-time employees), with an exclusion for the first 30 workers. Thus a firm with no more than 30 full-time workers would not pay a penalty even if part-time workers caused them to be classified as large.

Using 50 employees as the point at which the penalty applies and assuming all full-time employees, a firm with 50 employees,[6] would pay an average of $800 per employee (50-30)/50. The 50th employee would trigger a cost of $40,000, the 51st and after $2,000. The average per employee would decline as employee size rose: $800 per employee for a firm with 50 employees, $909 for 55 employees, $1,000 for 60, $1,200 for 75, $1,400 for 100, $1,880 for 500, and so forth, until the average approaches $2,000 at a very large size.

If a large firm offers coverage but one or more of those employees receives a premium credits or cost-sharing reductions, the payment is $3,000 for each of those employees.

[5] Note that there is an inconsistency in the law as one section of the bill indicates that a large employer is one with 50 employees, while other sections discussing modifications (such as those for seasonal workers) indicate that a large employer is one where the workforce is more than 50. The first would imply a trigger between 49 and 50 employees, while the second would imply a trigger between 50 and 51 employees.

[6] As noted above, the cut-off point is not clear from the legislative language.

Small Business Credit

Small businesses with less than 25 full-time equivalent employees and/or with average wages less than $50,000 may be eligible for a credit of 50% of the employer's payment for two years, beginning in 2014. There is a transitional credit of 35% for 2010-2013 as well. The employer must pay 50% of the health plan cost. The credit is against income tax, so small employers without tax liability will receive no current benefit and small employers with inadequate tax liability will not receive the full current benefit. Credits can be carried backward one year (except in the first year offered) and forward 20 years plus another year.

Tax exempt entities, such as charities, are eligible for a 35% credit (25% during the transition) taken against payroll taxes.

The credit is phased out both by size and average income in an additive fashion. The credit is reduced by the number of employees over 10, divided by 15; the credit is also reduced by average wages over $25,000 divided by $25,000. A business with 10 or fewer employees and $25,000 or less in average wages will receive a credit of 50%. If the wages remain at $25,000 or less but employee size rises to 15, the credit is reduced by 33.3% (15 minus 10, all divided by 15, or 1/3) or, for a 50% credit, to 33.3%. If average wages are $30,000 but size is 10 or less, the credit is reduced by 20% ($30,000 minus $25,000, all divided by $25,000), or, for a 50% credit to 40%. If both occur, both phase outs are added, so that a firm with 15 employees and $30,000 in average wages both the 33.3% and the 20% apply for a reduction of 53.3%. This phaseout would reduce the 50% credit to 23.3%.

Original House Proposals Relating to Small Business

The original House bill, H.R. 3200, was considered by three committees of primary jurisdiction, and it was referred to five committees. The three committees of primary jurisdiction are Energy and Commerce, Ways and Means, and Education and Labor. The proposal provides for penalties on firms that do not provide 65% of the cost of family health insurance (72.5% for single coverage), with exemptions for small firms. A subsequent proposal, approved in the Energy and Commerce Committee, apparently intended to exempt employers with a payroll under $500,000 from the mandate. H.R. 3200 as reported by the other committees would exempt employers with a payroll under $250,000. H.R. 3962, which is based on the reported versions of H.R. 3200, uses the $500,000 exemption in the Energy and Commerce version of H.R. 3200. H.R. 3962 passed the House on November 14, 2009.

Table 1 shows the penalties for firms that do not offer insurance based on a $500,000 level exemption. It also shows the subsidy rate in 2013 for aiding low-wage employees in small businesses, in the form of a general business credit allowed through the income tax. The credit is not available to employers without income tax liability, and the full credit may not be available to employers with small liabilities. The credit is based on the employer's payment toward insurance coverage. The credit is not allowed to firms for employees with compensation over $80,000, but all dollar amounts are indexed for inflation. Small businesses can purchase insurance through the exchange, which disallows variations in premiums based on health status. It is allowed for two years.

Table 1. Provisions of H.R. 3962 in 2013

Employer Penalty or Credit	Provision
Pay or Play Penalty Payroll Level	**Percentage of Payroll**
$500,000 or less	0%
$500,000 to $585,000	2%
$585,000 to $670,000	4%
$670,000 to $750,000	6%
Over $750,000	8%
Subsidy for Low Wage Employees	**Rate and Phase Out**
10 or Fewer Employees	50% for Employer Contribution, for Compensation Less than $20,000
Compensation Phase Out	Between $20,000 and $40,000
Firm Size Phase Out	Between 10 and 25 Employees

Source: H.R. 3962.

Original Senate Proposals Relating to Small Business

Senate health care proposals were originally reported by two committees of primary jurisdiction: the Senate Health, Education, Labor, and Pensions (HELP) Committee (S. 1679) and the Senate Finance Committee (S. 1796). The current Senate bill, H.R. 3590, adopts elements from both proposals. It exempts businesses with 50 or fewer employees from the penalty as in S. 1796 (S. 1679 used a 25-employee cut off). H.R. 3590 has been adopted by the House and signed by the President, but the penalty structure is modified by the reconciliation proposal, H.R. 4872, which is discussed below.

H.R. 3590 adopts a flat $750 penalty (as in S. 1679) for firms with over 50 full-time employees who do not offer insurance, and have at least one employee that receives a premium credit. (This penalty level, taken from S. 1679, is larger than the penalty in S. 1796.[7]) The premium credit to employees is available if the employer does not provide 60% of the cost, and applies to individuals between 100% and 400% of poverty. It limits payments for health insurances to shares of income ranging from 2% to 9.8%.[8] Firms that offer insurance but have employees who receive the credit will have to pay a penalty of $3,000 for each affected employee, but capped in the aggregate at the amount for firms that do not offer coverage. Firms with over 200 employees that offer coverage are required to have automatic enrollment in their plans, and firms with over

[7] In the Senate Finance bill, the penalty is triggered if firms pay less than 65% of insurance costs, and the firm would pay the lesser of the premium credit or $400 per employee. Penalties do not apply to part time workers at $375 as they would have under the HELP bill.

[8] CRS Report R40935, *Health Insurance Premium Credits in Senate-Passed H.R. 3590*, by Chris L. Peterson and Thomas Gabe explains the credits.

50 employees are assessed a penalty of $600 for any employee in a 60-day or longer waiting period.[9]

The subsidy for small business in H.R. 3590 is similar to that in S. 1796, and the subsidy structure is the same as the House provisions shown in **Table 1**, except that the subsidy is phased out between $25,000 and $50,000. It is allowed for firms that pay at least 50% of the health insurance premium. H.R. 3590 begins the credit in 2010; beginning in 2014 the phaseout amounts are indexed for inflation. The bill also allows a credit against payroll taxes for tax-exempt organizations, at a 35% rate.[10]

Final Legislation and the Reconciliation Bill (H.R. 4872)

The final legislation adopted the Senate proposal, but with changes in a reconciliation bill. The reconciliation measure modifies the Senate penalty structure by changing the dollar amount to $2,000 but exempting the first 30 employees. This change would lead to a slightly larger payment per employee, which rises from $854 per employee for a firm with 51 employees and rises to approximately $2,000 per employee. Firms that do offer coverage would have their caps affected by the change. It also counted part time workers.

Potential Impact of Special Provisions on Small Business

Small businesses would be affected by the mandate and the exemptions from the mandate, by the penalties under the pay or play rules, by credits for purchase of insurance, and by the community rating aspects of the proposal.

The Mandate and Exemptions

The number of small businesses potentially affected by the mandate for health insurance depends both on the distribution of firms and the number that already offer insurance.

[9] In the Senate Finance bill, S. 1796, firms with more than 50 employees would have to pay 65% of insurance or would have to reimburse the government for any low-to-moderate income individuals who obtain premium and cost-sharing subsidies, up to a *maximum* of $400 per employee for all employees (whether eligible for a personal credit or not), whereas H.R. 3590 imposes the per-employee penalty as long as one employee receives a subsidy. A penalty similar to the Finance Committee bill applies in cases where coverage is offered; however, H.R. 3590 does not include a $375 penalty for part time workers.

[10] In S. 1679, businesses with 50 or fewer workers whose average wage is less than $50,000 would receive assistance in the form of credits if they provide at least 60% of health insurance costs. These credits, for each employee plan, are $1,000 for self-only plans, $1,500 for two adults or an adult and child plan, and $2,000 for a family plan. There would be an increase of $100, $300, and $400, respectively, for each payment of 10% of the cost, in excess of the 60%, by the employer. The payments would be allowed in full for firms with 10 or fewer employees, and reduced to 80% of these amounts for those with 11 to 20 employees, 50% for 21 to 30, 40% for 31 to 40, and 20% for 41 to 50. Self-employed individuals would be eligible as well. The credits would be indexed to wage inflation, but allowed for no more than three consecutive years. (Note that there are delays in the effective dates).

Small businesses are quite concentrated as micro-businesses with very few employees. As shown in **Table 2**, 61% of firms in the United States have four or fewer employees and almost 80% have less than 10 employees.

The Senate and House proposals differed on what characteristics determine the exemption: the Senate proposal was based on number of employees and the House proposal was based on size of payroll. In general, the Senate proposal is likely to be more generous because 25 employees would exceed a $500,000 payroll at $10,000 per employee, a lower-than-average wage.

For the original Senate HELP Committee proposal which exempted firms with 25 employees, all of the first three classes in **Table 2**, which amount to 89.3% of all businesses, as well as a part of the fourth class would be exempt from the mandate. Thus, more than 90% of firms would be excluded from any mandate. The first three classes account for 18% of employees in the United States; thus, approximately one-fifth of employees would not be covered by the mandate. The Senate Finance Committee and H.R. 3590 have a 50-employee cut off. This proposal was adopted. While it is difficult to interpolate the numbers in **Table 2**, it appears that about 95% of businesses would fall under this exemption and over a quarter of employees.

Table 2. Characteristics of Firms in the United States, 2006

Number of Employees in Firm	Percentage of Firms	Average Payroll ($)	Percentage of Work Force
0-4	60.9	62,596	5.0
5-9	17.6	201,866	5.8
10-19	10.7	436,866	7.2
20-99	8.9	1,384,522	18.0
100-499	1.5	7,297,315	14.6
500 and Over	0.3	147,398,418	49.5

Source: U.S. Census, Statistics of U.S. Businesses, http://www.census.gov/econ/susb/.

For the House proposal with a $500,000 wage level, the exemption could only be approximate, because there would be variations in payroll.[11] However, based on the average payroll per firm reported in **Table 2**, it appears that the first two classes and probably at least three-quarters of the third would likely be excluded under a $500,000 exemption, accounting for 86%-87% of firms. This number is consistent with news reports that indicate the $500,000 amount would exempt 86% of firms.[12] About 16% of employees would be exempt.[13] However, without adjustments for

[11] The percentages in this paragraph were estimated assuming the average wage is the midpoint of the distribution, which provides only an approximation.

[12] See, for example, Heather Rothman, et al. *Tax Changes Expected as Part of House Deal on Health Care Reform*, Bureau of National Affairs, July 30, 2009, http://www.bnasoftware.com/News_Articles/News/Tax_Changes_Expected_as_Part_of_ House _Deal_ on_Health_Care_Reform.asp.

[13] Under the earlier version with the $250,000 exemption, most of the first two classes (about 78% of firms) would be excluded. About 10% of employees would be excluded. The Executive Office the President, Council of Economic Advisers, *The Economic Effects of Health Care Reform on Small Businesses and Their Employees*, July 25, 2009, cited above, reports that 77% of businesses would be excluded with a less than $250,000 payroll benchmark criterion mandate and that 87% would be excluded with a less than $500,000 payroll. These numbers sort by establishment size rather than firm size. The Medical Expenditure Panel Survey also provides data by establishment. See http://www.meps.ahrq.gov/mepsweb/data_stats/summ_tables/insr/national/series_1/2008/tia1.pdf.

inflation and real income growth, the share of firms excluded with a dollar limit would be smaller on enactment and decline over time. For example, with a 4% annual nominal growth rate, by 2013, when the program takes effect, the $500,000 value would be equivalent to $380,000, with closer to a quarter of the third category excluded, and with the overall share of firms excluded closer to 81%-82%. Thus, by adopting the Senate exemption of 50 employees, the effects on small business are lessened.

There are advantages and disadvantages to the alternative exemption approaches, which could be based on number of employees or size of payroll. An exemption based on number of employees is not likely to reduce the share of businesses exempt over time, although a dollar exemption indexed to wage growth would also keep the share relatively stable over time. The exemption based on payroll is relatively more beneficial to small firms with lower-wage employees, where the personal assumption of the cost may be more difficult.

The share of firms that would not be affected because they are either exempt from the mandate or are already providing health insurance would be larger than the share exempt from the mandate alone. **Table 3** shows estimates of the share of employees in firms with health insurance coverage, although the data are for 2002, the most recently available. It shows the percentage of employees actually covered (employees may decline coverage because they do not wish to pay their own share of the costs or because they are covered under another family member's insurance). **Table 3** also shows the average cost of coverage per covered employee for a family plan. These costs are similar and do not show a specific trend (the cost is larger for very small firms because employers pay about 80% of the cost; in other firm sizes average shares are between 65% and 75%).

Table 3. Health Coverage by Employer Size, 2008

Number of Employees in Firm	Percentage of Employees in Firms Offering Coverage	Percentage of Employees Eligible	Percentage of Employees Covered	Cost Per Employee Covered ($) Family Plan
Under 10	45.0	37.8	29.8	9,310
10-24	69.5	54.4	40.4	8,195
25-99	85.3	64.9	48.0	7,447
100-999	95.9	72.3	57.7	8,602
1000 and Over	99.0	79.4	63.1	9,370
All	87.7	68.4	53.9	8,904

Source: Medical Expenditure Panel Survey, http://www.meps.ahrq.gov/mepsweb/SBAHQ03M0562, http://www.sba.gov/advo/research/rs262tot.pdf.

For the Senate HELP Committee proposal, data in **Table 3** are used to estimate that roughly another 7% of firms may be firms that are not eligible for the exemption, but already are providing coverage.[14] Thus about 97% of firms would not be required to offer coverage that they

[14] The 7% is based on 8.9% times 0.642 plus 1.5% times 0.723 plus 0.3% times 0.794. Note, however, that this is a rough estimate because the data reflect the percentage of employees and not the percentage of firms. In general, because of the rising coverage, the share of employees would be larger than the share of firms. However, if the average for the next lower category were used instead, which would likely be an understatement, the share would be 6%.

had not already offered. [15] This leaves only 3% of firms, mostly those with between 25 and 100 employees, who would be required to offer insurance or pay a penalty. An even smaller percentage of firms would be affected under the Senate Finance Committee plan and H.R. 3590, probably less than 2%. For the House proposal with a $500,000 limit, another 8.6% of firms are not eligible for the exception but are already providing health insurance; thus, more than 95% of firms would not be required to offer coverage that they have not already offered, leaving 4% to 5% of firms affected. This share would fall slightly due to the lack of indexing.

Effect of Penalties

If firms subject to a mandate do not offer insurance, they are subject to a penalty in certain circumstances. In the Senate bill, H.R. 3590, which is likely to be somewhat less burdensome for firms, the penalty is $750 for each full-time employee if one employee receives a premium credit. It does not apply to firms with 50 or fewer employees. (The Senate Finance Committee plan, where firms with 50 or more employees who do not offer health insurance would have to reimburse the government for any low-to-moderate income individuals who obtain premium and cost-sharing subsidies, up to a maximum of $400 per employee for all employees, would be even less onerous.) Based on the maximum, the penalties appear to be smaller than in the other proposals.

The House proposal applies the penalty as a percentage of payroll, so the penalty would be less for firms whose employees earn less. **Table 4** shows the average wage by employer size. Note that the average wages for the smallest firms are actually higher than those for mid-sized firms (but not for the very large firms). As noted in **Table 2,** the penalty as a percentage of income rises by payroll size and can be imposed at a 2%, 4%, 6%, or 8% rate. Given earnings of around $35,000 for the smallest non-exempt category, these amount to penalties per employee of $700 (2% of $35,000) for the smallest firm category of $500,000 to $585,000. For the larger percentages (4%, 6%, and 8%) the amounts would be $1,400, $2,100, and $2,800. The penalties in the House proposal appear, therefore, to be greater in most cases than those in the Senate proposal.

Table 4. Average Earnings Per Employee by Firm Size, 2006

Number of Employees in Firm	Average Earnings Per Employee ($)
0-4	38,547
5-9	30,707
10-19	32,524
20-99	35,200
100-499	37,680
500 and Over	44,612

Source: U.S. Census, Statistics of U.S. Businesses, http://www.census.gov/econ/susb.

The reconciliation proposal would provide effects that, like the House proposal, would rise with the firm size, although the penalties would apply to fewer firms because more firms are exempt

[15] The total of 97% is the sum of the 90% not subject to the mandate and 7% subject to the mandate but already offering insurance.

(and those in the smallest percentage category in the House bill would likely be exempt under the Senate bill.. For example, a firm with 51 employees would pay an average penalty of $824, a firm with 75 employees would pay an average of $1200, a firm with 100 employees would pay an average of $1,400, and a firm with 500 employees would pay an average of $1,880. Thus, the reconciliation penalty amounts are larger than the original Senate bill but smaller than in the House bill.

In theory, penalties should help induce firms that fall under the mandate (i.e., are not exempted from penalties by size) and are not currently providing health insurance to do so. Although only about 3% of firms in the Senate proposal and about 4%-5% in the House proposal with a $500,000 exemption fall into this group, they are larger firms that employ a larger fraction of the work force. The share of employees falling into this category is about 22% of the workforce for the Senate HELP plan and the House plan with the $500,000 exemption; it is somewhat less for the Senate bill, H.R. 3590.

The penalty in the Senate bill is relatively small compared with the cost of insurance. According to the National Center for Health Care Reform, the premium in 2008 for a family of four was $12,700, with the individual paying $3,400, leaving the employer with a cost of $9,300.[16] The average cost for a single person was $4,700. Under the House bill, the employer must pay at least 65%, or over $8,000, for a family of four (under the Senate bill, the share is slightly smaller, 60%). These costs would be expected to be higher when the proposal is implemented. Note also that contributions employers make toward coverage would only be based on those who enroll.

Economic theory suggests the penalty should ultimately be passed through to lower wages and would not be a burden on small business owners. If firms cannot pass on the cost in lower wages, the higher cost of workers may lead firms to reduce output and the number of workers. (Individuals with lower incomes, however, should be able to receive subsidies in the community-rated pools, which will increase their welfare.) For the firm, paying a penalty may be more feasible than providing insurance, especially if their employees are lower income and the wage cannot be lowered below the minimum wage or the burden is too great.

The exemption approach in the Senate bills proposes a flat penalty per employee for firms with more than a specific number of employees and with at least one employee receiving a premium credit. The House proposal phases in the penalty amount by discrete firm size. The reconciliation proposal also provides for an increase in the penalty as firm size increases.

Any exemption based on size can create disincentives for adding employees. When there is a flat rule that imposes the full penalty at a specific level (often referred to as a cliff), an additional employee or dollar of payroll at that point will trigger a significant cost and discourage expansion. By phasing in the penalty as employee size or payroll rises, the cost will rise more smoothly and the disincentive at any specific point will be smaller.

For example, for the Senate bill, assuming full-time employees, the addition of the 51st employee would cost $38,500 ($750 times 51) in penalties, and each employee after that one would trigger an additional cost of $750. With a 25-employee cut off, the addition of the 26th employee would have been $19,500 (26 times $750). An initial proposal in the HELP Committee plan would have exempted the first 25 employees; the additional penalty cost of an employee after the first 25

[16] See http://www.nchc.org/facts/cost.shtml.

employees is $750 per employee. Similarly, if the firm has no employees that trigger the premium credit and are above the limit, hiring a lower-income employee would trigger a large cost.

The House proposal has a phase-in, although it is not smoothly imposed and results in smaller cliffs. Without a phase-in, the first dollar in payroll after $500,000 would result in a penalty of $40,000.08 (0.08 times $500,001). With the discrete phase-in, the first dollar in payroll after $500,000 would trigger the 2% penalty on all payroll, $10,000.02 ($500,001 times 0.02). Every dollar after that point would trigger an additional $0.02, until the firm reaches $586,000, when the increase in the penalty to 4% would be triggered. At that point the penalty would rise by $11,704 ($585,000 times 0.02 plus $0.04). Penalties of this general magnitude would be triggered at each discrete point when the percentage rises.

The reconciliation proposal (H.R. 4872) means that the 51st employee would trigger a payment of $2,000 times 21 (because the first 30 employees are exempt), or $42,000. Thereafter, each employee will add an additional $2,000.

Another approach would be to phase in the penalty over some level of employees or income. For example, to phase in the House penalty smoothly between $500,000 and $1 million, the $500,000 exemption would be reduced for each dollar over $500,000. For a firm with a $600,000 payroll, the exemption would be $400,000 ($500,000 minus the amount of payroll over $500,000). Over the phase-in range, the cost of adding a dollar of payroll would be $0.16 per dollar (the dollar would result in its own penalty of $0.08 and the phase-in would add another $0.08) until the phase-in is complete. The penalty after the phase-in is $0.08 per dollar. A similar phase could be applied to a plan based on employee size, as in the Senate proposals.

Credits for Smaller Firms

Under the original Senate HELP proposal, a credit would be offered through a government program, whereas in the House, Senate Finance Committee, and final Senate bills, credits would be an income tax credit. Under the income tax credit, firms' credits would be limited to income tax due, which could be smaller than the allowed subsidy, and firms without profit and tax liability would not receive a benefit (although there would be carryovers and carrybacks). A special provision in the Senate Finance Committee plan and the Senate bill (H.R. 3590) would allow a subsidy (at a lower rate) for small tax-exempt charitable organizations (but limited to payroll taxes).

The credits are intended to encourage coverage and are targeted at the firms not subject to penalties (as discussed above). For very small firms and very low-income workers, the subsidy is significant, but it declines as incomes and firm size rise. Where it applies, the full subsidy is larger in the House bill, the Senate Finance plan, and the Senate bill (H.R. 3590) than in the Senate HELP plan given the general cost of insurance. For example, if the insurance cost for a single worker is $4,700, then 72.5% of the cost is about $3,400, and 50% of that cost would be $1,700, covered by the subsidy in the House bill. For the Senate Finance Committee and final Senate proposals, if 50% is paid by the employer, the subsidy is $1,175. The House, Senate Finance Committee, and final Senate (H.R. 3590) subsidies are phased out quickly as average wages rise, however; so in that respect the Senate HELP plan is more generous. The final Senate bill (H.R. 3590) is more generous that the House and Senate Finance Committee plans, as the phaseout occurs between $25,000 and $50,000 in average wages rather than $20,000 and $40,000. In both plans almost all exempt businesses would be eligible for the full subsidy because they have 20 or fewer employees. Without more data on the dispersion of wages within the firms

it is not possible to estimate how many employees would be in firms eligible for the employer credit. The House, Senate Finance Committee, and final Senate bill (H.R. 3590) subsidies are phased out smoothly without any cliffs; the Senate HELP proposal has cliffs (see discussion of cliffs in the previous section) based on firm size.

Benefits of Community Rating

For some small firms, the ability to buy insurance through the insurance pool that restricts variation in premiums, including disallowing charges for preexisting conditions and limiting differences by age, will be a significant benefit. As with individuals, very small firms that have individuals or families whose health care is more costly will be more easily able to purchase insurance. These additional costs will be spread across many other individuals and will remain attractive to many healthy individuals because of the individual subsidies. Thus, they should reduce the problem of adverse selection.[17] Firms with healthier employees would see a rise in costs.

Taxes on Incomes of High-Income Individuals

The original House proposals would have imposed a surcharge on high-income individuals, which raised some issues concerning small business, originally on incomes above $350,000, but the final House bill imposed a tax only on incomes over $1 million for married couples and $500,000 for singles. H.R. 3962 would, according to the committees' summary, affect 0.3% of taxpayers.

The Senate proposal, H.R. 3950, which has been passed and signed into law, imposes a 0.9% Medicare tax on earnings of married couples over $250,000 and singles over $200,000.

The reconciliation proposal, H.R. 4872 would impose a 3.8% Medicare tax on the passive income of those with incomes over $250,000 (couples) and $200,000 (singles), limited to the excess of income over these amounts or total passive income, whichever is smaller. According to Tax Policy Center estimates, these taxes would affect 2.6% of taxpayers.[18]

This section first reviews the issues raised by the House surtax. It then addresses the effects, by comparison, of the Medicare tax.

House Surtax

Particular concerns were expressed about the effect of the surtax in the House bill on small businesses, job creation and entrepreneurship. Most smaller businesses are unincorporated or treated as such by the tax system with income flowing through to the proprietor or partner and are thus subject to the individual income tax. Only about 4% of businesses would be affected by the

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[17] These issues are discussed in Executive Office the President, Council of Economic Advisers, *The Economic Effects of Health Care Reform on Small Businesses and Their Employees*, July 25, 2009, http://www.whitehouse.gov/assets/documents/CEA-smallbusiness-july24.pdf.

[18] Estimates at http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2679&topic2ID=60&topic3ID=73&DocTypeID=

original surtax,[19] and, according to the committees' outline, only 1.2% would be affected by the revised surtax.

A larger share of income, as opposed to taxpayers, would be affected. For example, returns with more than $1 million account for 15.1% of adjusted gross income, according to IRS statistics, but only 0.2% of returns. Taxpayers with income more than $500,000 account for 22.4% of income, but 0.7% of returns.[20] These statistics indicate the degree to which income is concentrated at higher-income levels.

In addition, business income is more concentrated in higher-income levels than other types of income. Overall, labor income accounts for about three-quarters of overall income, with the remainder divided almost evenly between passive capital income (interest, dividends, and capital gains), pensions, and business income. In the top 1%, labor income is less than half of income. Individuals with incomes more than $1 million account for 27% of unincorporated business net income for businesses with positive income, and individuals with incomes more than $500,000 account for 38%. This concentration primarily reflects partnership and Subchapter S firms rather than proprietorships.[21] Returns with adjusted gross income of $1 million or more accounted for 7.5% of total proprietorship income, whereas returns with income more than $500,000 accounted for 12.6%. For partnerships and Subchapter S firms (corporations that elect to be taxed as partnerships), returns more than $1 million accounted for 40.8% of net income and returns with income more than $500,000 accounted for 55.7% of net income. Supporting this finding, a 2007 Treasury study indicated that taxpayers at the top tax rate (constituting a similar share of returns to those covered by the surcharges) are responsible for 61% of business flow-through income.[22]

Some of the income in partnership and proprietorship incomes may reflect passive income and income from tax shelters, however. According to IRS data, almost 85% of partnership income is in limited liability companies or limited partnerships. Thus, these business income shares include passive income, rather than income involved in active business, and also significant income that is in businesses that are not the new and innovative firms that are often the focus of those concerned with entrepreneurship and job creation. The Treasury study indicated that these high-income taxpayers accounted for only 46% of active, positive business income. Supporting this notion that many of these businesses are not active, the Tax Policy Center found that of the returns affected by the surtax with business income, only 22.8% had business income that was more than half of total income.[23] This small income share also suggests much of this income is passive investment income that, absent the current rules that permit firms to operate with limited liability but not be subject to the corporate tax, would be in the form of corporate dividends and capital gains, not active business operations.

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[19] Data from the Joint Committee on Taxation, reported by the Ways and Means Committee in "Paying for Reform," http://waysandmeans.house.gov/media/pdf/111/pfr3200.pdf.

[20] Internal Revenue Service, Statistics of Income, 2006.

[21] Unincorporated business income for tax purposes is in three forms: businesses run by a single owner (proprietorships), businesses run by partnerships (multiple owners) and Subchapter S corporations (small businesses that are incorporated but elect to be taxed as proprietorships or partnerships). See CRS Report R40748, *Business Organizational Choices: Taxation and Responses to Legislative Changes*, by Mark P. Keightley.

[22] Treasury Conference on Business Taxation and Global Competitiveness, July 23, 2007, http://www.treas.gov/press/releases/reports/07230%20r.pdf.

[23] Tax Policy Center, Table T09-0351, Distribution of Tax Units with Business Income, http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=2426&DocTypeID=7.

Data suggest that while business income may be somewhat more concentrated than income overall, much of small business income is associated with passive investments, stockbrokers, lawyers, doctors, and accountants who are unlikely to be innovators or important sources of job creation for lower and moderate income individuals. Trade, construction, and most services are also unlikely to be important sources of innovation, which is an argument advanced for providing relief to small businesses. Thus, very little of the increased tax revenue is likely to be collected from the businesses that are associated with innovation, entrepreneurship, or important sources of new jobs.

About two-thirds of partnership income reflects finance, real estate, oil and gas extraction (which includes passive partnerships), and services (such as doctors and lawyers).[24] About 8% of total income was from real estate and oil and gas respectively, 19% from finance and insurance (with almost 80% of that total from securities and investment firms), 15% in professional services (with about 60% of the total legal services) and 5% in health (with about half of that total for physicians and dentists).

Subchapter S firms are more broadly distributed. Subchapter S income is about 40% of the total of Subchapter S and partnership income. According to the IRS data for 2006, the single largest share of Subchapter S income is in trade (19%) followed by manufacturing (14%), construction (13%) and professional services (11%). Finance, insurance, and real estate accounts for about 9%. Most of the remaining third is in some form of services.[25]

In addition, questions could be raised about the argument that small businesses are important as sources of new jobs. Small businesses create more jobs but also are the greatest sources of job loss. They create more net new jobs, but, according to Edmiston, this evidence is not entirely clear because of migration across size classifications; moreover, although this sector of the economy may offer more opportunities to women and minorities, it pays less, is less stable, and has fewer fringe benefits.[26]

Aside from the issue of the number and quality of jobs, standard economic theory suggests that there is no need for a permanent policy to create jobs in general. Although a stimulus aimed at creating jobs may be needed in an economic downturn and programs to improve skills of marginal workers could increase labor force participation, economic theory, again, suggests that a permanent policy directed at job creation would be unnecessary, and also inefficient if it misallocates resources. As the economy grows, it naturally creates its own jobs as evidenced by the growth in the employment over time.

If a major objection to the surtax is the effect on small businesses, income from selected types of business operations (presumably not for lawyers, doctors, or stockbrokers) could be excluded from the surcharge. Flow-through income is a larger share of income of the top 1% (about one-quarter) than of the population as a whole (about 9%).[27] An exclusion of all flow-through income would sacrifice around a quarter of revenue, but the loss would be much smaller if passive

[24] Internal Revenue Service, Statistics of Income, 2006.

[25] Internal Revenue Service, Statistics of Income, 2006.

[26] Kelley Edmiston, "The Role of Small and Large Businesses in Economic Development," Federal Reserve Bank Kansas City, Economic Reviews, 2nd Quarter, 2007, pp. 73-97.

[27] CRS Report RL33285, *Tax Reform and Distributional Issues*, by Jane G. Gravelle.

income and income from finance, real estate, insurance, oil and gas extraction, and professional services were not permitted an exclusion.

Medicare Taxes on High Income Taxpayers

The concerns about the Medicare tax seem somewhat lessened in the case of small business. Although it will affect more individuals, the rate is lower. Small business owners' investments in their business, however, will be affected relatively less than other types of investment. For proprietorships and partnerships, the Medicare tax is already paid on active business investment income simply as a part of earnings from a trade or business, so the additional tax will be only 0.9%. Subchapter S firms can report separate amounts for wages and other income, so the Medicare tax would apply to higher wages but active income is excluded. Thus, either because it is already taxed or explicitly excluded, the 3,8% tax will not apply to active business income. (It will apply to passive income, such as dividends, interest, and capital gains other than from assets held in a trade or business, and to passive income in a business.

Although there are no separate estimates for small business, the tax is relatively modest for most taxpayers. According to distributional data for a similar tax by the Tax Policy Center, with a 2.9% rate on investment income, the average dollar amount of tax paid in the $200,000 to $500,000 income class would be $425. On average, this amount was one-tenth of 1% of income.[28] Correcting for the higher rate of 3.8%, the most this amount could be is $557, if all the income taxed in excess of the thresholds were unearned; if half of income were unearned and half earned, it would be $489.[29] In the next higher-income class of $500,000 to $1,000,000, the tax was $4,162, six-tenths of 1% of income. (If adjusted for the higher tax rate, it would be $5,453 if all taxed income were unearned and $4,786 if half were earned).

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[28] Distributional data are available at http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2679&topic2ID=60&topic3ID=73&DocTypeID=.

[29] With all income subject to tax unearned, the tax would rise by 3.8/2.9, or 31%. If half were earned and half were unearned, the tax would be 0.5X(3.8-2.9)/(0.5*0.9+0.5*2.6) or 15%.