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HEALTH INSURANCE:
Availability and Adequacy
for Small Businesses

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Monopolies and Business Rights
Committee on the Judiciary
U.S. Senate



Summary

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

About half of small businesses with less than ten employees do not offer health insurance coverage to their employees, with cost and insufficient profits being the two most important reasons cited for not doing so.

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

- the inability of small employers to spread risk of substantial health care costs over a large number of employees and the consequent greater chance that just one or two employees with serious illnesses will lead to huge premium increases,
- the increase in the use of insurance premiums that are based on the experience of individual companies (experience rating) rather than the broader community (community rating),
- competition among insurers for businesses that present lower risk, and consequent higher costs for businesses with worse experience, and
- rapid turnover of firms insured by an insurance company.

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

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss problems which small business have in providing health insurance to their employees. On May 22, 1990, we issued a report addressing restrictive changes in employer-sponsored health insurance plans by both small and large firms.¹ Today's focus is on small business, and we will discuss the problems that employees of small businesses face in obtaining adequate and affordable health insurance coverage. While all firms are having problems with rapidly rising health care costs, our findings indicate that the workings of the small business insurance market create unique problems for small firms that exacerbate the impact of rising costs affecting firms of all sizes. In group health insurance, actuaries consider any group with less than 25 employees to be small.

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

¹Health Insurance: Cost Increases Lead to Coverage Limitations and Cost Shifting (GAO/HRD-90-68, May 22, 1990).

of increase one and a half times the rate experienced by the nation's largest firms.

Probably the most important effect of rising costs is the inability of a substantial number of employees of small firms to obtain group health insurance. The smaller the firm, the less likely it is to offer health insurance. Almost half of the working uninsured are employed by businesses with fewer than 25 employees. Of the 8.2 million uninsured private wage and salary workers in 1984, 3.9 million were employed by a firm with fewer than 25 employees.

Erosion of the Small Business Health Insurance Market

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

- the inability to spread risk over a large number of employees,

- the decline of the availability of community rated health insurance products,

- competition among insurers to offer coverage only to the best risks,
- medical underwriting practices, and
- rapid turnover of firms insured by an insurance company.

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

In the past this dilemma has been avoided through a system known as community rating--a mechanism for spreading risks more broadly. Under community rating the premium is based on the average cost of actual or anticipated health care used by all subscribers in a particular geographic area, industry, or other broad grouping and does not vary for subscribers (individual companies) within each grouping. Therefore, an individual firm's

premium generally is not further adjusted for such variables as its own claims experience on the health status of individual workers. Blue Cross plans in most states have traditionally offered community rated plans to small firms.

Greater competition in the insurance marketplace has led to the erosion of community rating. Commercial insurers were able to select from the community pool small businesses which were better risks and offer them lower rates, thereby raising the rates for the higher risk firms remaining in the pool. As commercial insurance companies continued to siphon off the firms with the lowest expected health costs, the ability to spread risks in community rated plans diminished. As a result, community rated health insurance products became less available. Even Blue Cross/Blue Shield plans have had to reduce the extent of community rated health insurance.

Restrictive Underwriting Practices

Small businesses are currently in a market where some insurers are attempting to move costly industries, firms or individuals out of their pool through restrictive underwriting practices.² Medical underwriting often results in the exclusions of some employees from coverage if they have preexisting

²Underwriting generally refers to insurance companies' criteria and decisions as to which risks to accept or exclude from coverage.

conditions such as cancer, diabetes, heart disease or other high cost illnesses. In some cases such individuals may be denied any coverage, and in other cases only the specific preexisting condition is excluded. This underwriting may also limit the coverage available to spouses and dependents of the employee.

Another underwriting practice employed by some insurers of small firms is to exclude selected types of businesses. Small firms in entire industries sometimes are excluded from coverage by insurers. While the list of excluded industries varies by insurer, there is considerable overlap. Among the many types of businesses that various insurers exclude are logging, mining, roofing, taverns, hair stylists, and medical offices.

Some insurers do not cover a number of industries where the risk of illness or injury appears to be greater than average, such as logging or roofing. With high-risk occupations, the concern is not only with health care costs but also the legal expense of determining whether workers' compensation or health insurance is to be the primary payer. For instance, some insurers do not cover

- physicians or lawyers because they believe it is too expensive to deal with fraud, abuse, and litigation for small firms in these areas;
- entertainment or sports industries because of the perceived high risk of drug abuse treatment costs; and

-- barbers, beauticians, and decorators because of their assumptions about the higher risk of AIDS and sexually transmitted disease generally.

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

Turnover, Pricing, and Underwriting

Because of the factors discussed above, workers in small businesses may face particular problems if they change employers or if their employers change insurance companies--a frequent occurrence. Based on our discussions with several companies who provide insurance to small businesses, it appears that nearly a third of the insured firms leave these insurance companies or are not renewed each year.

First year costs for a small business policy are considerably lower than the costs for subsequent years because of medical underwriting and preexisting condition exclusions. In the second

and subsequent years some preexisting condition exclusions expire and the covered population begins to develop new conditions leading to higher costs. Higher costs generate the need for rising premiums. In the face of these higher premiums, many small businesses respond by seeking a new insurer who will offer them a lower first year rate. Problems for employees will arise if they had a serious illness or even a pregnancy which began under the lapsing insurance contract. These employees may well find themselves excluded from necessary coverage under the new insurance company.

Similar problems occur for workers who are changing jobs or have recently lost their job. Providing transitional coverage is another important issue for small business. They have higher labor force turnover rates and longer waiting periods before health coverage begins than larger firms do. Further, at termination of employment small firm employees usually do not have the option of continuing their health insurance coverage at group rates. Current laws mandate this option only for firms with 20 or more employees. For firms with 20 or more employees, the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) requires that employers offering health insurance benefits offer employees separating from the firm (other than for gross misconduct) the option of continuing health coverage for up to 18 months. For such employees electing this option, the premium will be no higher than 102 percent of the group rate, payable by the

employee. The Omnibus Budget Reconciliation Act of 1989 extends the period for continuing group health insurance coverage for the disabled for an additional 12 months. During the period, the premium will be no higher than 150 percent of the group rate, payable by the employee.

Proposals for Addressing Problems

Insurance experts and groups concerned with improving access to insurance for employees of small firms suggested a number of options to lessen problems in the small business health insurance market. These include:

- encouraging or requiring greater use of community rating,
- eliminating pre-existing condition clauses,
- encouraging portability of health insurance benefits,
- guaranteeing renewability of insurance policies for all covered individuals, and
- providing subsidies to high risk pools.

The first and second options, setting rates on a community-wide basis and eliminating pre-existing condition clauses, were among the insurance market reform recommendations made to the Congress by the U.S. Bipartisan Commission on Comprehensive Health Care (the Pepper Commission) in March 1990. The Pepper Commission further recommended that there be no denial of coverage for any

individual in a small group and that there be guaranteed acceptance of all groups wishing to purchase insurance.

The third, fourth and fifth options, encouraging portability of benefits, guaranteeing renewability, and developing mechanisms to fund high risk pools, were among approaches recommended by the Health Insurance Association of America in February 1990.

There have been some attempts to deal with the problems in the small business market by state government creation of assigned risk pools and industry group creation of multiple employer welfare arrangements (MEWAs)³. However, these have met with mixed success. Because of developing financial problems in some MEWAs and concerns about fraud and abuse in this market, the National Association of Insurance Commissioners last month called for increased scrutiny of MEWAs.

In conclusion, our work has indicated that in many instances workers in small businesses are uninsured or underinsured due to financial pressures on their employers compounded by the nature of the small business health insurance market. While a number of options have been proposed, after much study there is still no consensus and the nation has not yet embraced a solution to this problem.

³These arrangements are sometimes referred to as multiple employer trusts, or METs. Multiple employer welfare arrangements, however, is the term defined in federal law.

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Mr. Chairman, this concludes my statement. I would be happy to answer any questions that you or members of the Committee may have.