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Blueprint for Opportunity

No. 23

Implementation Memo

TO: Governor Ritter
Members of the 66th Colorado General Assembly

FROM: The Bell Policy Center – Robin Baker, Senior Policy Analyst

DATE: February 20, 2007

**RE: Implementing Bell's Blueprint recommendation No. 23
to help small businesses through community rating.**

In the 2006 Blueprint for Opportunity, the Bell Policy Center recommends:

Help small businesses provide health insurance coverage for their employees

We should continue to require insurance companies to offer small employers and individuals low-cost health insurance policies that provide basic services and protect families from excessive medical expenses.
(See *Blueprint*, page 32)

This memorandum briefly discusses the issues surrounding this proposal, describes steps for implementing it, outlines some of the factors to consider and lists sources for additional information and resources.

If you are interested in pursuing this issue further, we are prepared to work with you. Please contact the author of this memo directly at (303) 297-0456 or baker@thebell.org, or Rich Jones, director of policy and research, at (303) 297-0456 or jones@thebell.org.

Overview of the issue

Most working adults and their families get their health care coverage through their jobs, but it's becoming too costly for many small businesses to offer this benefit to workers.

That's because health insurance premiums are more costly for small firms and because of the risk selection methods the insurance industry uses to set premium rates, such as community, modified community or band rating.

More than half of the nation's private sector workers are employed by a small business. In today's economy, small businesses create new jobs at a faster rate than larger employers.¹ Small business clearly dominates the working landscape. Equally clear is the fact that many small businesses cannot afford to provide health care for workers over the long run. Research

consistently shows that as health costs go up, fewer small employers offer health plans to their workers and fewer workers can afford to participate in health plans offered by their employer.

The erosion of employer-sponsored health insurance is most prevalent among very small firms with 10 or fewer employees. In 2005, 61 percent of all private sector firms in Colorado employed 10 or fewer workers.² While no data is available to show the number of uninsured adults working in these very small firms, we do know that between 2003 and 2005, 63 percent of Colorado's uninsured adults worked in businesses with fewer than 100 employees.³

While the current employer-based system of providing health care to workers may not be sustainable in the long run, data suggest that in the short run, providing affordable health



Glossary of insurance terms

Small business: In Colorado's small group market, a small employer is defined as a business group of one and firms with two to 50 employees.

Small group market: Where firms with two to 50 employees purchase health insurance plans for workers. Colorado allows self-employed people – called groups of one – to also participate in the small group market. The small group market is primarily governed by state law. Employers purchase an insurance contract from a licensed health insurer or health maintenance organization (HMO), which takes on the full financial risk for paying insurance claims. Insurance products are guaranteed issue.

Guaranteed issue: The requirement that health plans must permit enrollment regardless of health status, age, gender or other factors that might predict use of health care. All health plans sold to individuals and small employers in Colorado must be guaranteed issue.

HIPAA: The federal law that outlines requirements for employer-sponsored group insurance plans, insurance companies, and managed care organizations.

Base premium rate: Defined in state law as the lowest premium rate charged or that could have been charged to small employers with similar case characteristics for health benefit plans subject to state regulation. (See CRS 10-16-102 (3))

Index rate: The rate all small group carriers are to charge to small employers, adjusted for case characteristics of age, geographic area and family composition. The index rate is the arithmetic average of the applicable base premium rate and the corresponding highest premium rate for small employers with similar case characteristics.

High-risk pool: Any arrangement established and maintained by a state to provide health insurance to residents who, because of their poor health history, are unable to purchase individual coverage or can only buy coverage at a rate substantially above that offered by the high-risk pool.

Community rating: Sets health insurance premiums at the same level for all individuals or groups in a defined community.

- Under **pure community rating**, low-risk and high-risk applicants are charged the same premium for the same coverage.
- Under **modified community rating**, premium costs vary based on age, gender or geographic location, but not on health status.

Adverse selection: Disproportionate enrollment in health plans of individuals with more health problems. Over time, as plan premiums rise due to higher health care costs, the plan becomes less attractive to healthy potential enrollees while attracting more unhealthy enrollees in successive enrollment cycles. This results in upwardly spiraling costs.

Medical underwriting: The practice of setting a firm's premiums based on a calculation of expected medical costs as determined by an assessment of the health status of the enrollees. It's most common among small firms.

insurance through small businesses is critical to reducing the number of uninsured Coloradans.

Since World War II, employer-sponsored health plans have provided the primary source of health coverage for the majority of workers and their families. Indeed, most of the financing for private health insurance comes from employers contributions to worker health insurance premiums. Until Colorado is able to identify other means for financing private health insurance, the state must do whatever it can to make sure that the existing employer-based system of providing health insurance continues to serve as many Colorado families as possible.

We encourage the governor and the legislature to take an important first step in helping small businesses provide affordable health insurance coverage by restoring community rating in the state's small group market — the market where firms with fewer than 50 employees purchase health insurance plans for workers. Moreover, restoring community rating to the state's small group market will establish a stronger market foundation for health care reform.

Small businesses pay higher costs

Soaring health care costs, the unpredictability of the small group market and the inability to spread health risk over larger numbers of people are the biggest threats to small employers trying to purchase insurance coverage for their workers.

As costs go up many small employers drop coverage and others decide not to offer health plans at all. In a 2006 nationwide survey, 74 percent of small businesses (employing three to 50 workers) cite high premiums as a major reason why they did not offer health coverage.⁴ Nationally, the cost of employer-based coverage increased 68 percent since 2001.⁵

Small firms pay about 10 percent more for the same benefit plan as do larger firms. From 20 to 25 percent of premiums paid by small firms cover administrative expenses, such as marketing and billing, compared to 10 percent for larger firms.⁶ Moreover, high premium costs have led more small firms to offer plans with fewer benefits and higher deductibles compared to health plans offered by larger companies.⁷

Small group premiums are higher, in part, because health care costs for small firms are less stable and harder to predict.⁸ One employee or dependent in poor health can dramatically affect health care costs for a small firm. In contrast, large insurance risk pools have the advantage of spreading catastrophic health care costs over a wider range of low-risk and high-risk workers and their families. This economy of scale helps to stabilize premium variations and lower the overall cost of premiums.⁹

Since small group insurance is largely regulated by states,¹⁰ states can create their own economy of scale through community rating.

**Community rating:
spreading risk, expanding coverage,
keeping premium costs down**

The purpose of health insurance is to spread risk among many people so costs are more predictable. Spreading risk protects everyone in the pool from the catastrophic costs of a illness or injury while holding premium costs down.

Under community rating, all policy holders within a particular small group are charged the same premium regardless of age, health status, gender or other factors. Research finds that pooling risk is less data intensive and can create substantial economies of scale by cutting administrative costs, limiting total spending, moderating risks and making insurance more available and affordable.¹¹ Moreover, since the insurance rating structure is simplified, an insurance company’s rating practices become more transparent.

Critics of community rating argue that it creates adverse selection. (See definitions.) Available research examining community rating and adverse selection is inconclusive. However, researchers stress that because so many factors exert influence on the small group market — from the health of the general population to uncompensated care costs — identifying direct correlations is nearly impossible.

Research does identify a few common tendencies. For example, small and mid-sized firms with community ratings generally have lower per-enrollee health care costs. Further, since participating in health insurance plans is voluntary, healthier people are more likely to opt out, regardless of premium costs. Finally, some research suggests that when individuals purchase insurance directly for themselves and are later added into a small-group market community-rated pool, health care costs for everyone increase from 3.4 percent to about 11 percent per year.¹²

Colorado’s small group market

Under HB94-1210, Colorado adopted premium rating rules that were suggested by the National Association of Insurance Commissioners. Under this provision, the state allowed small insurers to vary premium rates for small group plans based on age, geography and family size,. In other words, Colorado’s small group market used modified community rating to set base premium rates. The 1994 law also added a “business group of one” (BG1) to the definition of a small group. Under this definition, sole proprietors had guaranteed access to small group coverage.



In 2003, insurance companies reported that national carriers were leaving the state's small group market because of Colorado's modified community rating structure. In response, the legislature passed HB03-1164, which allowed insurers covering small group to adjust premiums up or down based on factors such as claims experience, smoking, workplace characteristics or health problems such as diabetes.

This practice is referred to as group bands, rating bands or rating adjustment factors. As part of the 2003 bill, small business must submit an application to small group insurers that includes health information for each employee.

Research examining the impact of rate bands on premium costs and insurance coverage, much like research on community rating regulations, is inconclusive.¹³ However, consumer-based research finds that the difference between the highest premium rate and the lowest premium rate for the same health insurance plan is larger under rating bands than under adjusted or modified community rating.¹⁴

According to a 2007 Colorado Department of Insurance report, rate bands that were implemented in 2003 encouraged more small group insurers to sell policies in the state and insurers reported greater profits.¹⁵ However, the 2005 Annual Small Group Survey, the latest available from the Colorado Division of Insurance, shows that the number of small employer groups covered by health insurance has decreased for five consecutive years. Between 2000 and 2005, the number of small employer groups covered by health insurance dropped by 34 percent, from 70,270 to 46,368.¹⁶

Implementation steps

In Colorado, small group insurance premiums begin with an insurance carrier's base premium rate (CRS 10-16-102(3)). From this base, premiums are adjusted to an index rate based on age, geographic area, family composition and the health status of the employer's group of workers (CRS 10-16-105(3)(e) and CRS 10-16-105(8)(f)(I)), also known as rate bands.

- **Restore the community rating methodology used for Colorado's small group market.** This process could be phased in over time, beginning with the elimination of health status, followed by the elimination of claims experience and standard industrial classification.
- **Designate an impartial agency to report back to the legislature in four years regarding the effect of community rating on the small-group market, employers and employees.** In 2007, the Colorado Division of Insurance conducted an evaluation of itself of the new band rate methodology on the small-group market and reported the findings to the General Assembly (pursuant to CRS 10-16-105(8.7)). Results of the report include only those responses from insurance carriers offering small group products in Colorado.

Factors to consider

The state's effort to encourage small group coverage fundamentally depends on a stable small group insurance market. Ensuring adequate participation among the young and the healthy is one of the most challenging aspects. Small employers cannot spread their risks among a large pool of workers. The voluntary nature of health insurance means that there will always be individuals opting out of health insurance plans. To stop this pattern, Colorado should consider creating a statewide community rating pool that requires all individuals living in the state to be covered by a standard health insurance plan.

Though the small group market is largely regulated by the state, it is also heavily influenced by factors such as the state's

economy, the age and health of the population, people changing jobs or opting in and out of insurance plans, the number of uninsured and the strength of safety-net programs.

Community or modified community rating is used by every state initiating comprehensive health care reform.

It is imperative that the state of Colorado acknowledge and begin to address the reality of our changing economy and workforce. Research indicates that small business dominates the working landscape. Traditional jobs found in manufacturing, construction and mining are giving way to service, information and technology jobs — jobs that better fit a small business environment. It is also clear that many small businesses do not have the resources to sustain an employer-based system of health care benefits for workers and their families.

Since the 1940s, most workers and their families have received insurance through their employers. In 2007, Colorado and the nation depend on employer-based health insurance to finance the bulk of private health insurance. Increasingly, employers are struggling to subsidize private health insurance. Until the state and the federal government recognize the reality and the impact the new economy has on working people and families, and until new methods for funding private health insurance are established, we will endure more uninsured, rising uncompensated care costs and worse health outcomes nationwide.

Information and resources

☎ Dede de Percin, executive director
Colorado Consumer Health Initiative
(303) 839-1261

☎ Kelli Fritts, associate state director advocacy representative, AARP
(303) 764-5991

📄 Report to the Colorado General Assembly on Rating Flexibility Pursuant to CRS 10-16-105(8.7), Colorado Commissioner of Insurance (2007).

www.dora.state.co.us/Insurance/pb/rateflex07.pdf

📄 Fewer Groups Covered by Colorado's Small Group Market, 2006 press release, Colorado Department of Regulatory Agencies, Department of Insurance.

www.dora.state.co.us/Insurance/pb/sga042006.pdf

📄 [Risky Business: When Mom and Pop Buy Health Insurance for Their Employees](#). Task Force on the Future of Health Insurance issue brief, from the Health Research and Educational Trust, Commonwealth Fund, 2004.

📄 Health Insurance Coverage for Small Employers, National Health Policy Forum, The George Washington University, 2005.
www.nhpf.org/pdfs_bp/BP_SmallBusiness_04-19-05.pdf

📄 Fundamentals of Underwriting in the Nongroup Health Insurance Market: Access to Coverage and Options for Reform, National Health Policy Forum, The George Washington University, 2005.
www.nhpf.org/pdfs_bp/BP_Underwriting_04-13-05.pdf



End notes

- ¹ U.S. Small Business Administration (2006). [Small Business Drives the U.S. Economy](#), Press Release No. 06-17 ADV0. Office of Advocacy, U.S. Small Business Administration. In 2005, according to the U.S. Small Business Administration, small businesses — defined as 500 employees or less — represented 99.7 percent of the nation’s employer businesses. More than half, 50.6 percent, of the nation’s private sector workforce were employed by a small business
- ² Medical Expenditure Panel Survey data. Downloaded Jan. 12, 2007, from MEPS-IC State Tables, 2004. Agency for Healthcare Research and Quality, U.S. Department of Health and Human Services.
- ³ Colorado Health Institute (2005). Profile of the Uninsured in Colorado, an Update for 2005. www.coloradohealthinstitute.org/documents/PolicyBriefs/Uninsured.pdf
- ⁴ Kaiser Family Foundation (2006). Kaiser Public Opinion Spotlight, [Public Opinion on the Uninsured, updated January 2006](#).
- ⁵ Kaiser Family Foundation and Health Research and Educational Trust (2006). Employer Health Benefits 2006 Annual Survey. Kaiser-HRET, Employer Health Benefits. www.kff.org/insurance/7527/index.cfm
- ⁶ General Accounting Office (2001). “Private Health Insurance: Small Employers Continue to Face Challenges in Providing Coverage,” GAO-02-8. There are no reliable data comparing insurance costs for the same benefit packages between large and small firms. While insurance companies would have the best information, their data are proprietary. www.gao.gov/new.items/d028.pdf
- ⁷ Ibid.
- ⁸ Gabel, J.R. & Pickreign, J.D. (2004). “Risky Business: When Mom and Pop Buy Health Insurance for Their Employees,” Task Force on the Future of Health Insurance, Issue Brief, Health Research and Educational Trust, Commonwealth Fund. [www.cmfwf.org/usr doc/gabel riskybusiness ib 72_2.pdf](http://www.cmfwf.org/usr_doc/gabel_riskybusiness_ib_72_2.pdf)
- ⁹ Williams, C. and Lee, J. (2002). [Are health insurance premiums higher for small firms?](#) Policy Brief No. 2. Robert Wood Johnson Foundation.
- ¹⁰ The Health Insurance Portability and Accountability Act of 1996 (HIPAA) requires guaranteed issue of individual coverage for people with prior continuous coverage in the group market. In addition, under federal law, small group health insurance must be offered to small business on a guaranteed issue basis. That is, small business cannot be denied health insurance coverage on the basis of the health status or illness of its employees or their dependents. However, businesses regardless of size are not required by law to offer insurance to employees.
- ¹¹ Buchmueller, T. C. and DiNardo, J. E. (2002) “Did Community Rating Induce an Adverse Selection Death Spiral? Evidence from New York, Pennsylvania and Connecticut,” *American Economic Review*, Vol 92(1):280-294; America’s Health Insurance Plans (AHIP) Center for Policy and Research (2006). Small group health insurance in 2006: A Comprehensive Survey of Premiums, Consumer Choices, and Benefits. www.ahipresearch.org/pdfs/FINALSmallGroupPaper.pdf ; Robert Wood Foundation (2005) [Making Health Insurance More Affordable for Small Businesses](#); Gencarelli, D.M. (2005). “Health Insurance Coverage for Small Employers,” National Health Policy Forum, George Washington University. www.nhpf.org/pdfs_bp/BP_SmallBusiness_04-19-05.pdf
- ¹² Ibid., Robert Wood Johnson Foundation.
- ¹³ Williams, C.H. and Fuchs, B.C. (2004). [Expanding the individual health insurance market: Lessons from the state reforms of the 1990s](#), The Synthesis Project, Policy Brief No. 4. Robert Wood Johnson Foundation.
- ¹⁴ Senkewicz, M. (2006). [Senate health bill would preempt states’ small group rating rules](#), Center on Budget and Policy Priorities.
- ¹⁵ Colorado Commissioner of Insurance (2007). Report to the Colorado General Assembly on Rating Flexibility Pursuant to CRS 10-16-105(8.7). www.dora.state.co.us/Insurance/pb/rateflex07.pdf
- ¹⁶ Fewer Groups Covered by Colorado’s Small Group Market, press release, Colorado Division of Insurance. www.dora.state.co.us/Insurance/pb/sga042006.pdf