Small Business Commission
December 6, 2010
Richmond, Virginia

The Small Business Commission held its third meeting of the 2010-2010 interim on December 6, 2010, in Senate Room A of the General Assembly Building. Co-Chairman Roscoe Reynolds presided. The meeting featured four presentations related to health care, the BPOL tax, and the economic outlook for small businesses.

Importance of Virginia's Health Care Industry

Larry Sartoris of the Virginia Hospital and Healthcare Association (VHHA) provided the Commission with an overview of the impact of the health care sector on Virginia's economy. His comments underscored that health care is a major employer with well-paying jobs and that Virginia's health care, when compared to other states, provides high quality at low costs.

Nearly 350,000 Virginians are employed at hospitals, ambulatory care, and nursing home facilities. Eight of the Commonwealth's largest 25 private employers are health systems. As of May 2010, 10.32 percent of private jobs in Virginia were in health care services, making it the third largest employment sector in the state (exceeded only by the professional and business services and retail trade sectors). Moreover, jobs in the health care sector pay well. Wages paid by VHHA members topped the average wages paid in 5 of 6 regions of the Commonwealth.

Data on Medicare reimbursements per enrollee indicate that Virginia is a comparatively low-cost state with respect to health care. At the same time, a 2007 report on health system performance found that ranked states in order of quality placed Virginia in the second quartile.

Many questions regarding implementation of the federal health reform legislation will remain unanswered until the Secretary of Health and Human Services issues regulations. Mr. Sartoris identified several areas where the health care industry will be affected. First, several new taxes and fees are levied on business. These include the tax on "Cadillac" health plans, fees on drug and medical device manufacturers and insurance providers, and penalties on employers that either do not provide health insurance, or do not provide affordable coverage, for their employees. These and other new taxes on wealthier individuals will have a redistributional effect on Virginia's economy, which now ranks seventh in terms of relative prosperity.

Second, the federal law mandates that Medicaid eligibility be expanded to cover everyone whose income is less than 133% of the federal poverty level. This change is expected to increase the number of enrollees in Virginia's Medicaid program by 50% to as many as 425,000 individuals. This provision removes the General Assembly's historical ability to control the costs of its Medicaid program by setting eligibility requirements. It also limits the ability of states to control Medicaid program costs by determining the coverage, such as pharmaceutical benefits, that is provided to enrollees.

Third, Mr. Sartoris explained that the new law provides federal subsidies at varying levels for individuals whose income is less than 400% of the federal poverty level. He observed that the subsidy levels are pegged to insurance premium levels. As a result, residents of states with more expensive health care insurance will receive proportionately larger federal subsidies than will residents of low-cost states. The federal law may make it more difficult for employers to offer high-deductible health plans. The new health care law also raises the prospect that some employers will make the economic decision to pay the penalty for not providing health coverage for their employees.

The new health care exchanges may provide some level of relief for small businesses. Exchanges are intended to allow individuals and small employers to shop for health coverage from among competing approved plans. While exchanges have already been established in Massachusetts and Utah, Mr. Sartoris noted that the oldest functioning exchange is the federal employee health benefit plan. One proffered benefit of health care reform is the reduction in cost shifting from uninsured patients who receive care at emergency rooms. It is estimated that this cost shifting results in a 33% increase in the cost of private health insurance. However, Mr. Sartoris observed that emergency room visits have increased in Massachusetts since the state's reforms took effect. The increase was attributed in part to the shortage of primary care providers able to accept newly insured persons into their practices. He also noted that a portion of the cost shifting is the result of shortfalls in federal reimbursement payments for services under the Medicaid and Medicare programs.

Patient Protection and Affordable Care Act

Susan Maley Rash, Vice President of BB&T Insurance Services, provided an overview of the federal Patient Protection and Affordable Care Act (PPACA) and the ways it may affect small businesses. The mammoth federal health care reform legislation defines "small business" in a multitude of ways under provisions that take effect in stages between 2010 and 2018. Effects on small businesses include added uncertainty and new taxes.

An area of uncertainty to many employers offering health care coverage to employees is whether their plans qualify as "grandfathered" under PPACA. Grandfathered plans are exempt from several PPACA requirements, including a provision that prohibits discrimination by an employer in favor of highly compensated employees with respect to health plan benefits and eligibility.

Ms. Rash noted that PPACA contains some positive elements. It establishes a tax credit for businesses with fewer than 25 employees that provide health care coverage. The amount of the credit, which varies by state, in 2010 is $407 for employee-only coverage and $945 for family coverage. The Act requires employers with 50 or more employees to furnish "reasonable" breaks to nursing mothers. Ms. Rash also praised the incentives for wellness programs included in PPACA.

Other aspects of PPACA that Ms. Rash addressed include high risk pools for uninsured persons with preexisting coverage (in which only 8,000 individuals have enrolled nationwide), health benefits exchanges, and the penalties to be assessed on employers with 50 or more full-time equivalent employees that either do not provide health care coverage or that provide employee coverage that is deemed to be unaffordable. The test for whether coverage is affordable is based on an employee's ability to obtain a federal tax credit subsidy through a health benefits exchange.

Subsidy eligibility depends in part on whether the employee's share of the cost of coverage under the employer's plan exceeds a certain percentage of household income. For an employee whose family income is 400% of the federal poverty level, the threshold for subsidy eligibility is whether the employee's costs exceed 9.5% of household income. An employer that fails the affordability test is subject to a penalty of $3,000 per year for each employee who obtains a subsidy in an exchange, not to exceed the amount of the penalty that would be due if the employer did not provide any employee health care coverage ($2,000 per year for each employee but excluding the first 30 employees).

Another aspect of the impact of PPACA on small business is its filing requirements. Employers will be required to expand the information reported to the Internal Revenue Service on W-2 forms. Though Congress has debated its repeal, another reporting burden is the expansion of the Form 1099 requirement. Starting in 2012, all companies are scheduled to be required to issue 1099s to any individual or corporation from which it buys more than $600 in goods or services in any year. This requirement, which was added to PPACA as a revenue enhancement measure, will require businesses to issue millions of new tax documents each year. These requirements will also require small businesses to reprogram their computer systems at considerable expense.

Evaluation of Virginia's BPOL Tax

Christine Chmura of Richmond-based Chmura Economics and Analytics presented the Commission with the results of a study of the business, professional and occupational license (BPOL) tax. The study, which was commissioned by the Virginia Retail Federation, evaluates the relationship between BPOL taxation and a firm's profitability. Ms. Chmura concluded that Virginia retailers pay a higher percentage of profits than the industry average and that there are widespread differences in the effective BPOL tax rates as measured both by industry and by localities.

Virginia's localities are authorized to assess a BPOL tax, and all 39 cities and 47 of 95 counties collect the tax. The tax is based on a business's gross receipts and is assessed at rates that vary among business categories. Moreover, the tax rates and business categories vary among those localities that levy a BPOL tax.

The study attempted to assess the effective rate of the BPOL tax by measuring the relationship between tax liability and total profits. The Virginia Code sets maximum BPOL tax rates for business classifications. The maximum rates were set by the General Assembly in 1987 after studying industry profit margins. The tax reflected an implicit assumption that businesses should pay equal taxes as a percentage of profits rather than gross receipts. However, the maximum rates have not been revised in 30 years.

The study relied on data obtained from IMPLAN Pro 2007 that estimates the profit margin for various economic sectors. Multiplying the estimated profit margin by the statewide average BPOL rate on gross receipts, the study calculates the effective BPOL tax rate, expressed per $100 of profits. The highest effective BPOL tax rate was determined to be assessed on professional and technical service firms at $13.99 per $100 of profits. The retail trade's rate was determined to be $1.56 per $100 of profits. However, the effective BPOL rate varies within the retail sector depending on the type of retailer because of the range of estimated profit margins. Ms. Chmura reported that the effective BPOL rate for the categories of retailers ranges from $18.27 to $0.47.

Ms. Chmura told the Commission that tax increases reduce investment and reduce gross domestic product. She cited a 1995 brief by the Tax Executive Institute that concluded that BPOL taxes should be repealed because gross receipts taxes are blind to a business's ability to pay the tax. In addition to being "unfair," gross receipts taxes are biased against new businesses because they often do not ear profits in the first year. In addition, inconsistencies among jurisdictions were said to prevent the adoption of best practices.

The presentation closed with a discussion of alternatives to the BPOL tax. Options offered by Ms. Chmura included replacing it with other taxes, creating consistency across jurisdictions and across industries, taxing profits rather than gross receipts, and exempting start-up businesses. Delegate John Cox observed that eliminating the BPOL tax without providing localities with an alternative source of revenue will be difficult. Senator Barker raised the issue of the difficulty of allocating the profits of a company that operates in multiple localities among the localities that elect to impose the BPOL tax.

<u>Small Business Performance in Virginia and the Region</u>

Robert Schnorbus of the Federal Reserve Bank of Richmond gave the members of the Commission a snapshot of the national economy, Virginia's labor market, and a small business perspective. He concluded that the recovery of the U.S. economy so far has been sub-par and remains sluggish and fragile. Virginia's employment picture has been better than that of the nation's, but seems to have lost steam lately. Small business employment, particularly in the service sector, experienced an unusual decline during the recent recession. While small businesses in the region are experiencing tight credit, they are primarily being constrained by weak demand for their products and services. Finally, he observed that small businesses are reluctant to expand hiring. This reluctance is likely to contribute to a sluggish economic recovery in the Commonwealth.

National gross domestic product has shown positive growth for the past five quarters, following shrinkage of the economy in 5 of the 6 preceding quarters. In the third quarter of 2010, the rate of growth was 2.5%. Virginia's labor market fared comparatively well in the recession, with a decline between December 2007 and December 2009 of 113,000 jobs, or 3% of its workforce. The national average was a decline of 5.2%. Virginia's job loss percentage was 39th worst among all states. However, the distribution in job losses has not been uniform among regions of the state, and the Danville area was cited as being worse than average.

Virginia's small businesses (defined as having fewer than 50 employees) experienced more job losses in the 2008-2009 recession than in the two preceding recessions (1990-1992 and 2001-2003). Employment by such firms in the Commonwealth fell by 2.2% in the most recent recession; in the prior two recessions, employment grew by 2.3% and 2.5%. The loss of jobs in service-producing small firms in the 2008-2009 recession was unique; in other recessions those jobs were safe.

The prospects for recovery in the labor market remain sluggish. A survey of small businesses revealed that 79% believe that the fourth quarter of 2010 is not a good time to expand. Over 70% of respondents cited economic conditions as a reason not to expand. The second most frequent answer, given by 14.1% of respondents, was the political climate. The small business optimism index in the Fifth Federal Reserve District remains around 95 (based on a 1986 figure of 100). While this level reflects a bounce off a low floor, it has leveled off at a point consistent with that in earlier recessionary periods.

The outlook for economic growth nationally, as of November 2010, calls for the steady increase of GDP growth over the next four quarters, though at rates lower than were seen in earlier post-recessionary periods. The outlook for small business expansion remains at recessionary levels. With regard to employment growth, it is projected that the economy will not recover the jobs that were lost in the recent recession until the end of 2012. In response to a question by Marilyn West, Dr. Schnorbus predicted that the likely primary driver of an economic recovery will be the housing market.

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