The Impact of Health Reform on Businesses

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Table of Contents

Executive Summary 1

Introduction and Background 2

Employer Mandates 3

Tax Changes 7

New Paperwork 10

Conclusion 12

Notes 13

Executive Summary

The health industry officially accounts for one-sixth of the American economy.[1] Yet the effects of reforms to our health care system will go far beyond the health care sector and will impact every business in the United States.

The reforms in the Patient Protection and Affordable Care Act (PPACA), along with the Health Care and Education Reconciliation Act (both passed in March 2010), will have numerous far-reaching consequences for businesses. In particular, the new law will:

- Significantly restrict the choices of employers and their employees with regards to health insurance coverage
- Raise taxes on businesses and create significant new paperwork burdens
- Discourage job creation and growth in the economy

In evaluating this new health care legislation, it's important to consider not only how the new law impacts the medical system, health care costs, and quality of care provided but how the law affects businesses, workers, and the general economy. Unfortunately, as this policy brief details, this law will have a significant negative impact on the business climate, will discourage business expansion and job creation, and will slow economic growth.

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Introduction and Background

In March 2010, Congress passed the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act. The passage of this reform legislation followed nearly a year of heated debate after the inauguration of Barack Obama as president. One of his primary campaign promises had been to reform health care in the U.S. During the creation of the legislation, more liberal and progressive ideas, such as a single-payer program, were considered but ultimately did not make it into the legislation. Free-market approaches to reform received little consideration. The final product was a complicated, 2,000-page piece of legislation that included the creation of 47 new government bureaucracies that will regulate a variety of aspects of the health care industry and oversee the implementation of the law. Most notably, the law mandates that all individuals must purchase health insurance coverage and contains rules about what kind of coverage will be considered acceptable.

Together, these new burdens are likely to lead to less job creation and slower economic growth—the wrong direction for our already-struggling economy.

The actual execution of the law will take place in two phases. Starting now, in 2010, through 2014, the United States will shift more responsibility for health care to the government by enforcing individual provisions and mandates contained in the legislation. The second phase is scheduled to begin in 2014, after which the law will be completely implemented and the new system fully operational.

Any change to our health care system will necessarily impact businesses. For decades, employers have played a direct role in providing health insurance. During World War II, government-imposed wage freezes prevented firms from attracting workers with higher pay, so employers used generous benefits, such as employer-sponsored health insurance plans, to attract workers. [2] Employer-sponsored health insurance also enjoys a tax advantage, since employers do not have to pay taxes on these benefits. Today, approximately three-fifths of Americans under age 65 receive health insurance through their employers.[3]

Employers commonly offer the choice of individual coverage or coverage that includes spouses or dependents as well. Employers may pay the entire cost of health insurance for their workers, only part of the cost, or none of it. In recent decades, the costs of providing benefits like health insurance have accounted for an increasing portion of the average employee's total compensation package.[4]

As this policy brief details, the PPACA will significantly change how employers provide health insurance to employees by creating costly new mandates. The PPACA will also impact businesses by imposing higher taxes, increasing paperwork burdens, and creating other regulations on business. Together, these new burdens are likely to lead to less job creation and slower economic growth—the wrong direction for our already-struggling economy.

Employer Mandates

The Patient Protection and Affordable Care Act creates numerous mandates that will increase the costs of providing health insurance to employees. These mandates will make it more expensive to hire a worker—discouraging job creation—and, in some cases, encourage employers to cease providing health benefits altogether.

Changing the Rules

According to the new rules under the Patient Protection and Affordable Care Act for employers, all firms with 51 full-time workers or more must provide each employee with "minimum essential" coverage beginning in 2014. If they fail to provide such insurance, the firm must pay an annual $2,000 penalty per full-time employee. (Two half-time workers count as one full-time worker.) This penalty increases to $3,000 for any employee that qualifies for and receives government subsidies for coverage through the new exchange system, which is created by the PPACA.[5]

... 62 percent of small businesses have at least one "red flag" in their plan design that violates the PPACA mandates.

If an employee's income is not greater than 400 percent of the federal poverty line and his (or her) insurance payment toward his employer-provided plan is between 8 and 9.8 percent of his income (but he chooses against participation in the employer's plan), he may instead enroll in a subsidized exchange and—if his employer provides one—use a free-choice voucher. If employers provide free-choice vouchers for workers like these, the employers will not face penalties for failure to provide insurance benefits. A free-choice voucher for use in the exchange must be equal to what the employer would have paid for the employee's coverage.[6]

The federal government will define what constitutes "minimum essential" coverage, and those standards will be subject to change. As of now, policymakers have determined that this means employers must discontinue lifetime maximums[7] and cost-sharing for preventative services.[8] Annual maximums will be restricted in 2014 and prohibited altogether in 2016.

Other new rules for employers include the following: 1) no employee can face an enrollment waiting period greater than 90 days,[9] 2) firms with 200 or more employees must automatically enroll their workers in the office plan unless employees decline,[10] and 3) employers must provide a private space other than a bathroom for nursing mothers to express milk.[11] Also, the reform will lower the amount of money that employees can contribute to their health care flexible spending accounts.[12]

Mercer, a leading global health benefits consulting firm, determined in its 2009 National Survey of Employer-Sponsored Health Plans that 62 percent of small businesses have at least one "red flag" in their plan design that violates the PPACA mandates.[13] This means that the changes required by this health care reform will affect a majority of small businesses. Fourteen percent of businesses in the survey have *two* red flags.

As previously discussed, any firm with more than 50 employees that fails to provide adequate coverage for all employees will face a nondeductible fee equal to $2,000 multiplied by the number of employees. However, this fee won't be applied to the first 30 workers. As a result, a firm with 51 workers might decide to pay $42,000 to the government instead of bearing the costs of covering all of its employees. In fact, since the cost of providing adequate health insurance for all employees is certain to be significantly higher than the fine, many employers will have a significant incentive to stop providing insurance at all. Alternatively, the owner of a firm with 51 workers could fire the fifty-first worker to avoid being subject to the mandate at all.

If firms decide to drop health benefits rather than comply with costly new mandates, more people will be forced to enter into the subsidized exchanges, causing a greater burden to taxpayers.

Raising Costs

The mandates described above will raise costs for employers. Employers of more than 50 workers who have not previously offered benefits will face the greatest amount of new costs because they will be forced to enter the market or face a penalty. But even those firms that have been providing health insurance benefits will likely see costs rise, as they will be compelled to switch to plans that meet the government's definition of "essential." As employers seek to offer first-time plans or switch existing coverage, they will have to choose among a more limited number of options, as government mandates will also limit what insurance providers can sell.

All of these new mandates push average premium costs in one direction: up.

One such new mandate for insurers is that they must cover single adult children up to the age of 26 on their parents' policies. [14] Although this group of young people is generally a healthy group, the additional cost to insurance providers will cause premiums to increase in 2011. A report from Hewitt Associates estimates that along with the mandate to eliminate certain lifetime and annual limits, the age-26 rule will contribute approximately 1 percent to 2 percent of the projected 8.8 percent increase for 2011.[15]

One or two percent may not sound like a significant increase, but as more mandates are added, costs will continue to rise, and these one to two percent increases will add up to significant new burdens for workers and employers.

Insurers are also required to cover the costs of pre-existing conditions[16] in members and their dependents. Insurers will not be able to offer policies that include annual or lifetime maximums.[17] Also, the practice of "medical underwriting"—that is, denying coverage or charging higher premiums on the basis of health status—will be prohibited.[18] All of these new mandates push average premium costs in one direction: up. The only question is how much premiums will rise.

The market for group plans for small firms is already a small market. Because many large companies self-fund their insurance programs, they are exempted from state mandates and have more flexibility in the coverage they can offer. Small employers are subject to

state mandates. This means they generally face higher premiums than large firms. In fact, the Commonwealth Fund estimates that insurance premiums for small businesses are 18 percent greater than those paid by large companies. Moreover, administrative costs account for up to 25 percent of the cost of premiums for some small business health plans, compared to 10 percent for large firms.[19] Small businesses will face disproportionate burdens as a result of the new health reforms because they will have to comply not only with the mandates and rules for coverage in their individual states but with another list of mandates from the federal government. This will lead to higher premiums all around, thereby raising the cost of insuring each employee.

More likely, employers will take the higher costs created by these benefits from their overall employment costs. They may shorten hours, slow wage growth, or cut wages directly.

Businesses will have to find ways to compensate for the additional health care costs. Some might decide that the cost of insuring their employees is simply too high and will cease providing health insurance, thus shifting employees into the subsidized exchanges.

Alternatively, firms might choose to pass along the higher costs associated with this health care reform to consumers through higher prices. However, this would put smaller firms at a competitive disadvantage and, therefore, is unlikely to be the primary means of compensating for these new costs. More likely, employers will take the higher costs created by these benefits from their overall employment costs. They may shorten hours, slow wage growth, or cut wages directly. There will be a strong incentive to take workers off of payrolls—by reducing direct employment and making use of subcontracted work or temporary work—in order to avoid the requirement for health insurance coverage.

Encouraging Unfairness in Hiring and Employment

Not only does the health reform discourage hiring in general because of the higher costs of providing "essential" health insurance coverage, but the peculiarities of the law mean that employers will face greater exposure depending on *who* they hire, creating the potential for discrimination and unfair treatment in the hiring process and employment.

The expected insurance cost to an employer of a childless 26 year old is much lower than the expected cost of a single parent (with dependents) because of the mandates that might allow the former to stay on his or her parents' policy but might similarly require that the employer provide insurance to the children of the latter. This becomes a consideration not only during the hiring process but if downsizing takes place. Because of the greater costs involved in providing health care, employers will be faced with an incentive to evaluate and lay off workers based on their health insurance and income status.

Changing Health Savings Accounts and HC Flexible Spending Accounts

Beginning in 2011, the PPACA will double, to 20 percent, the penalty for nonqualified distributions from health savings accounts.[20] Starting in 2013, it will also limit the amount that employees can contribute to health care flexible spending accounts to $2,500 a year.[21] Previously, the total amount that could be contributed was left to the employer's discretion,

with many firms choosing a limit of $4,000 to $5,000 or so.[22] Starting in 2011, the law also bans using funds from flexible spending accounts, health reimbursement arrangements, or health savings accounts for over-the-counter medications.[23]

This limitation on the use of flexible spending accounts will make the purchase of over-the-counter medications more costly for individuals who have been using these accounts. To discourage the purchase of these self-treatment drugs is to encourage individuals to forgo this first attempt at self-care, which could lead to doctor's visits and prescription treatments that might have been avoided otherwise. This hurts not only the individuals who get sick but their employers, who rely on the health of their workers for productivity. Trips to the doctor or prescriptions that could have been avoided by having better access to over-the-counter drugs only raise costs to insurers. In the new system, these increased costs, like so many others, will affect everyone.

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Tax Changes

Because the credits only apply to very small firms with small average incomes, this provision effectively discourages growth, hiring, and wage raises in firms that are on the cusp of qualifying for the credit.

The total cost of the new health care law is estimated to be one trillion dollars over ten years.[24] To pay for this new spending, policymakers raise revenue by shifting money that was previously spent on Medicare and by levying numerous new taxes, many of which will impact businesses. In addition to the penalties employers (and individuals) face for failure to comply with mandates to obtain or provide employees with adequate insurance, the new law imposes direct taxes on income and investment.

Proponents of the new law have highlighted how tax credits for small businesses would ease the burden of providing health insurance for employees. Unfortunately, only a small fraction of businesses will qualify for any tax relief, and the tax credits are only temporary.

Tax Credits to the Smallest of Small Firms

Perhaps the main provision of the PPACA that has been praised as a "lifeline" to small businesses is the tax credit provision. A small portion of small businesses that provide health insurance to their workers will be eligible for a temporary credit.[25]

To qualify for the credit, a firm must have fewer than 25 workers, pay average earnings under $50,000, and pay for at least 50 percent of employees' premiums. Firms can receive the credit any year until 2013 and, after that, for two consecutive years of their choosing.[26]

Beginning in 2010, the credit is equal to 35 percent of employer contributions to qualified coverage for each employee. In 2014, the credit will increase to 50 percent of employer contributions. The overall tax credit will decrease by 6.7 percent for each additional employee beyond 10 workers. This means that very few firms will qualify. The National Federation of Independent Business estimates that only 35 percent of firms with fewer than 25 employees will qualify for the credit at all.[27]

Because the credits only apply to very small firms with small average incomes, this provision effectively discourages growth, hiring, and wage raises in firms that are on the cusp of qualifying for the credit. When employers consider adding valuable labor or skills to their firms in the form of more workers or workers with more education or greater skill, they make a cost-benefit analysis. By adding to the costs, the tax credit provision of the health care reform skews this analysis against hiring a new worker. In effect, if an employer wants to add a worker, the employer not only will have to come up with the money to pay the new worker's salary and benefits but will also face a higher tax bill, because the tax credit is reduced with each additional worker. This will raise the effective marginal tax rate on small business expansion and will discourage growth.

In addition to discouraging businesses from adding workers, the tax credit also discourages employers from increasing salaries, since average earnings have to remain under $50,000 for the firm to qualify for the tax credit, and the amount of the credit decreases as average earnings increase.

Consider the implications of this provision. For example, imagine two home-cleaning services of two workers each. Maggie is the boss of Cleaning Service M, and this year she paid herself $35,500. She paid her one employee, Molly, $25,500. Therefore, the average earnings for their cleaning service were $30,500 this year. Cleaning Service S didn't do as well: Sally, the boss, paid herself $29,500 and her one employee $19,500, for average earnings of $24,500. Because they earn more, Maggie and Molly won't qualify for as much of a health insurance tax credit as Sally and Sue. The government will provide a credit for 35 percent of Sally and Sue's employer contribution and 50 percent of it in 2014. For Maggie and Molly, the credit is less, only covering 21 percent now and 30 percent in 2014. This means that the bosses of both companies will have an incentive to not raise the wages of their workers. In fact, this provision may encourage Cleaning Service M to work less in order to qualify for a larger tax credit.

Income and Investment Tax Hikes

Starting in 2013, a 0.9 percent Medicare surtax will apply to wages in excess of $200,000 for single taxpayers and $250,000 for married couples.[28] Also, for the first time ever, a Medicare tax will apply to the investment incomes of high earners. The 3.8 percent levy will hit the lesser of 1) their unearned income or 2) the amount by which their adjusted gross income exceeds the $200,000 or $250,000 threshold amounts.[29] These thresholds are not indexed for inflation, meaning that more and more taxpayers will qualify for the tax in the future. The new law defines unearned income as interest, dividends, capital gains, annuities, royalties, and rents.[30] Tax-exempt interest won't be included, nor will income from retirement accounts.

This will be the first time that the government has imposed a Medicare tax on investment income.

From this description, it would seem that Congress targets the wealthy in order to finance the new health care law. Yet it is not only wealthy individuals who will be affected by these increased tax rates. Many small businesses file under the individual income tax code. The new tax laws will particularly affect those who work in real estate because the 3.8 percent increase on unearned income will greatly affect rental income.

This will be the first time that the government has imposed a Medicare tax on investment income.[31] If the Bush tax cuts expire, the 3.8 percent levy that takes effect in 2013 will raise long-term capital gains tax rates to 23.8 percent (for high earners). This will be the highest level of long-term capital gains taxes since 1997. [32]

According to a report from the Joint Committee on Taxation (JCT), this tax will account for $210.2 billion in revenues (more than half of the revenue projected to come from the new taxes and fees in the reform).[33] However, this analysis does not take into account how these new taxes will affect incentives and discourage hard work and investment. These

increases on income and interest taxation, along with the increases in insurance premiums, will raise the overhead costs of businesses and will make investing in business more risky and less profitable.

Direct Taxes on Certain Goods/Services

One of the provisions of the health reform legislation is a tax on "high-value" insurance plans. When this tax becomes effective in 2013, there will be a 40 percent excise tax on group health coverage that exceeds a threshold of $10,200 for single coverage and $27,500 for families. These values do not include separate dental or vision coverage. For retired people age 55 or older and for employees in high-risk professions, the thresholds are $11,850 for single coverage and $30,950 for families. Only the dollar amount in excess of the threshold will be subject to the tax, and the thresholds will be adjusted each year for inflation plus one percent.[34]

... one-fifth of middle-class households (those making between $50,000 and $75,000 a year) would be hit with this tax by 2019, and their total tax bill would be an average of $7,500 between 2013 and 2019.

It is important to note that the adjustment for inflation will use the general inflation rate (projected at 1.8 percent each year to 2019), which is much lower than the projected medical inflation rate (3.8 percent), and even lower when compared to the actual increases in health costs over the past five years (6 percent each year). [35] This means that if employers keep their group plans as they are now, more and more groups will be a part of this "high value" provision and will pay the excise tax. A study by Communication Workers of America analyzed numbers from the Joint Committee on Taxation and found that one-fifth of middle-class households (those making between $50,000 and $75,000 a year) would be hit with this tax by 2019, and their total tax bill would be an average of $7,500 between 2013 and 2019.[36] This tax will discourage businesses from providing the most generous health insurance plan to their employees. Millions of Americans will face a high tax bill as well as potentially more out-of-pocket costs for medical care, which means they will have less to spend or invest in other businesses.

There is another tax in the health care legislation that will have a huge effect on one group of small businesses: if the small business is a tanning salon, there will be a 10 percent tax on all sales.[37]

New Paperwork

The new health care law will also increase burdens on business by creating significant administrative and other paperwork requirements. This new burden will disproportionately affect smaller firms that may lack human resources or finance departments or that simply don't have the resources that must be dedicated in order to comply with the new law.

Reporting on W-2 Forms

The new health care law requires that businesses include on W-2s, beginning with W-2s for 2011, the value of the health care benefits they provide to employees.[38] The amount reported is not considered taxable income. However, the collection of this information may be a first step on a path to taxing those benefits as income in the future.

Additional 1099 Requirement

Businesses already file a Form 1099 for any payment to individuals that exceeds $600 annually. Now they must also file a Form 1099 for any payment to *another business* of $600 or more.[39] This applies to any purchase of services *or merchandise*. (This means, for example, that if a firm uses a caterer several times in the course of a year and the total bill exceeds $600, then a 1099 must be filed for that caterer.) This 1099 requirement applies to businesses of all sizes, charities, and other tax-exempt organizations and government entities.

Reportedly, the IRS estimated that about 85 million 1099 forms are filed each year. That number will jump significantly under the new law.[40] The National Small Business Association estimates that the average company now files about ten of these forms but, under the reform, will have to file approximately 86.[41] The SMC Business Council estimates that the time needed for one 1099 form is one half hour.[42]

In other words, this new paperwork requirement will divert time and resources away from productive activity, forcing businesses to spend millions, if not billions, filing additional paperwork.

According to the National Federation of Independent Business, at $74 an hour, tax paperwork is the most expensive paperwork burden that the federal government places on small business.[43] (With a little arithmetic, the average increase in costs for tax compliance to businesses that will have to file approximately 76 more 1099 forms is about $2,812 each year.) In other words, this new paperwork requirement will divert time and resources away from productive activity, forcing businesses to spend millions, if not billions, filing additional paperwork.

For small businesses that lack a finance department, the cost of tax code compliance is already 66 percent more expensive than the cost to big businesses,[44] meaning this additional 1099 requirement will only exacerbate an existing disadvantage. This requirement will make it necessary to use Tax ID numbers to track even the smallest of a firm's expenses. As a result,

small vendors that lack the capacity to track customer purchases may lose customers to large, national vendors that can more easily track the 1099 forms. This kills local competition, while at the same time putting a great burden on small businesses.

This new paperwork significantly threatens entrepreneurship. When it becomes more burdensome to operate a business on one's own, it becomes less attractive to start a new business. Entrepreneurship is a central component of the American economy and American innovation. To discourage this is to handcuff the potential progress of our nation.

Moreover, the increased paperwork and labor is likely to yield little new revenue for the government. Analysts question how the IRS can handle this many additional 1099s. While forms like the W-2 and 1099 are used to confirm the reported earnings of individuals, these new 1099s will not match businesses' tax returns and, therefore, seem of little use to the IRS.[45] The government hopes that this will help the IRS crack down on tax evasion. In fact, the JCT estimates that this provision will bring in a total of $17.1 billion in new revenue over the next ten years.[46] But this additional revenue will cost businesses much more than $17.1 billion because of the time cost and may not prove worth the trouble. Even the Taxpayer Advocate, an independent office within the IRS, is concerned "that the new reporting burden, particularly as it falls on small businesses, may turn out to be disproportionate as compared with any resulting improvement in tax compliance."[47]

Conclusion

… it will limit the choices previously made by employers and their workers, leaving Americans fundamentally less free.

Before the passage of the reform legislation in March 2010, it was clear that the U.S. health care system was in need of changes. The high number of uninsured Americans and the steeply rising costs of insurance were causes of concern for policymakers on both sides of the aisle. Unfortunately, the direction taken in the Patient Protection and Affordable Care Act, along with the Health Care and Education Reconciliation Act, will exacerbate, rather than solve, existing problems within the health care system and will create significant new burdens on businesses.

The reform will shift valuable resources away from capital investment and hiring over to paying higher insurance premiums and taxes, and it will shift valuable labor from productive business activities to tax compliance and paperwork, which will discourage job creation, lower productivity, impede business expansion, and slow economic growth. In addition, it will limit the choices previously made by employers and their workers, leaving Americans fundamentally less free.

The U.S. health system needs to be reformed, but this new law moves in the wrong direction.

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