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Adam Buchalski
Grand Valley State University

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TAX CREDITS AND HEALTH INSURANCE FOR THE SELF-EMPLOYED

ADAM BUCHALSKI

Grand Valley State University

This paper will look at how tax credits can help increase the affordability of health insurance among the self-employed in this country. Two of the problems involving health insurance are having enough and being able to afford it. These issues are especially true if you are part of the self-employed population in this country. Many of the self-employed have dropped health coverage or reduced it in the past few years due to rising costs. About 24 million of American small business employees and their families are uninsured according to a study by the Kaiser Family Foundation.

The research shows that if the self-employed could afford health insurance for their employees the number of uninsured would decrease. The government needs to step in to help make health insurance affordable for the working uninsured. The government has made some proposals that would help lower the costs of health insurance such as, Health Savings Account's, Flexible Spending Accounts (FSA's), and President Bush's Tax Credit Proposal. In my paper I will look at these as options for helping the self-employed afford health insurance and give my recommendation for a tax credit proposal.

Trying to find a way to make health insurance affordable for the self-employed interests me because I have relatives who are self-employed. These relatives pay a high premium for health insurance that is not nearly as comprehensive a plan that you would get from an employer-sponsored plan. Why should someone be subjected to unfair pricing just because they have decided to work for themselves? Many of these countries corporations started out as self-employed entrepreneurs that grew. Offering the self-employed segment of the population a way to afford quality health insurance can only be done with the government's help.

LITERATURE REVIEW

One of the most urgent problems our country has to address is the inability of the American health care system to resolve the problem of the increasing number of uninsured. After a small decline the number of uninsured people in the U.S. is on the rise again at over 45 million according to Gruber. Why should the people of this country care if there are those without health insurance? There has been a lot of literature written looking at the health effects associated with not having health insurance coverage. Most of the writings suggest that there is a correlation between an increase in health problems and no health insurance. Fisher suggests that by increasing coverage the United States could reduce mortality rates by around 10 percent among the uninsured. There would also be significant impacts on morbidity and perhaps productivity among those

who now have health insurance. The numbers showing the uninsured on the rise coupled with the growing evidence of negative health consequences associated with not having coverage have led to interest in policy options that might increase health insurance coverage in the United States. In order to increase health insurance coverage you have to identify who the uninsured are. Public perception is that the people with no health insurance are poor and unemployed. According to research from the Kaiser Foundation the majority of the population without health insurance are low-income workers, followed by people in transition. With the number of uninsured growing policymakers continue to debate what are appropriate methods for policy responses. The three methods that a lot of research has been done on are private employer coverage, public program expansions, and tax credits.

Employer coverage has long been the way that most citizens receive their health insurance. About 64% of all people have employer-based insurance coverage. Most people prefer that employers sponsor health insurance rather than having to seek coverage on their own. "A 2000 national survey found that 49% of Americans thought employers would be the best source of health insurance, 23% would rather purchase insurance on their own, and 18% said government would be the best source for insurance" (Feldman, 00).

Rising costs and premiums are wearing down employer-based health insurance. Many businesses especially small ones are dropping or cutting back on insurance coverage. Employees at some businesses are required to pay higher premium sharing, along with deductibles, and co-pays. Private businesses are not the only ones having a difficult time keeping up with expanding health care costs. State and federal budgets are being strained due to rising health care costs. Over the last few years' public programs are starting to cut back and some programs have had to cut eligibility. Medicaid and Medicare are experiencing cost increases. Average state Medicaid spending went up 25 percent between FY 2000 and FY 2002 (Fisher, 04). In recent health spending projections believe that private health spending will continue to grow faster than gross domestic product (GDP) for the rest of the decade.

What is driving spending in the health care market? There are a few different thoughts on the spending growth that has occurred over the last four years. Employers responding to their employees went with insurance plans that had easier referral and authorization rules. HMO's being portrayed as negative by the media may have also led to plans being more consumer-friendly, raising costs. Another factor that is constantly brought up for the rise in health care is the growing use of prescription drugs and other costly new technology. "While research shows that spending for prescription drugs grew much more rapidly than other types of spending, this accounts for less than a third of overall growth in private insurance costs. Growth in hospital and physician spending accounts for nearly half" (Gruber, Levitt, 00).

Employees wanted access to a broad range of hospitals and doctors. This led employers to use insurers who put together a more inclusive provider network, thus losing their ability to negotiate discounts since each insurer would cover only a percentage of each provider's patient list. Hospitals and other providers consolidating also weekend insurers clout. Rising underlying costs such as wage increases resulting from labor shortages, jump in energy prices, and an increase in malpractice premiums.

Many of the same factors have affected Medicaid spending. "Medicaid prescription drug costs more than doubled between 1995-2001" (Rosenbaum, 01). Increased caseloads and rising expenditures for long-term care, especially home care have driven up Medicaid spending.

With all of the costs increases in health insurance the question remains will the number of uninsured increase? If the cost of health insurance rises more quickly than people's incomes than one would think fewer people will likely obtain coverage. While this holds true over the long term, over the short term there are other factors that come into play on insurance. Most people do not buy their own health insurance; whether they end up having insurance usually depends on what their employer decides to do.

During the 1990s employers had a tight labor market and were prepared to absorb most premium increases. Even in 2000 and 2001 employee's premiums remained fairly constant and most workers saw little change in their benefits packages. Economic data from 2002 shows a downturn resulting in premium increases. Employers are beginning to use cuts in benefits packages and shifting costs to workers through higher cost sharing or increases in premium contributions. Due to the higher costs directed towards the employees, lower-income workers and those least interested in coverage might drop out or stop covering their dependents. Research by the Kaiser Foundation shows a relationship between higher required premiums and a reduced likelihood that workers will take up available employer coverage.

Small employers and the self-employed have less opportunity or no chance to shift more of the premium costs to the employees because of the minimum participation rates that many insurers require. Having the workers pay a larger premium may lead to less of them participating than the insurers' participation requirements will not be met. Smaller employees and the self-employed usually face higher premium increases than larger companies. One survey by the National Association of Self-Employed (NASE), found that a quarter of employers with fewer than 20 workers saw a premium increase of 30 percent or more for 2002. Some small businesses may drop their health insurance plans if premium increase continues at this rate.

Employers' costs for retiree health benefits are rising even faster than those for current workers. Companies have been cutting back on retiree coverage for years. Even larger firms have been cutting back. This has affected

supplemental benefits for Medicare retirees more than coverage of pre-Medicare retirees.

Average state Medicaid costs went up 25 percent in 2002 while economic hardship has slowed revenue growth. Since states are almost always required to balance their budgets, most states are planning to hold growth in Medicaid spending to around 6 percent. In order to achieve this goal states are going to cut benefits and reimbursements, and some beneficiaries may have to pay more of the costs of their care. SCHIP programs for low-income children will not be cut.

At this point most states have taken little action that is likely to increase the number of uninsured people. However with continuing budgetary pressure any interest the state may have had for widening insurance coverage could disappear.

So far in this paper we have talked about employer-sponsored health insurance and state funded health insurance programs. The last group that I will address is the non-group coverage population. Unfortunately because millions of people in our country work for small businesses or are self-employed; they do not get health insurance through work. This segment of the population is forced to pay for health insurance out of pocket or go without insurance. Many are deciding to go without health insurance because of the high costs. The self-employed are members of the non-group coverage and I will discuss how to lower health insurance costs for them.

Non-group coverage is coverage purchased directly by individuals and families, not through employers. There are no national surveys tracking growth in premiums for private non-group coverage. These premiums are no doubt increasing - recent growth may be on the rise more so than employer plans. Whether price growth for non-group insurance will lead purchasers to drop coverage is hard to tell. Individuals who cannot afford an increase may choose to have a more watered down version instead of dropping insurance altogether.

DISCUSSION

“According to the SBA’s Office of Economic Research, small businesses represent over 99.7 percent of all employer firms and 53 percent of the U.S. workforce” (Rosenbaum, 01). Looking at these numbers shows that a large percentage of this country’s workforce is self-employed and the number of uninsured could be significantly reduced if insurance were more affordable for this population. Here is a look at some of the proposed solutions to help with health insurance costs for the self-employed.

Association Health Plans (AHP’s) can help lower the number of uninsured by giving the self-employed the same purchasing clout, accessibility, affordability, and choice in health insurance that large companies have. The idea here is that small business could join together even across states through

their membership in a trade association. This would allow them to offer affordable health benefits to employees due to increased bargaining power, and administrative efficiencies. “Under proposed legislation, AHP’s would not be required to conform to state health insurance coverage mandates and insurance regulations one of the major factors many contend, that contribute to the rising cost of health coverage” (Meyer, 01).

Medical Savings Accounts (MSA’s) are another way to help with the costs of health insurance for the self-employed. MSA’s are tax-exempt personal savings accounts to be used for out of pocket medical expenses. A deductible of \$1,500 to \$2,500 for individuals and \$3,000 to \$4,500 for families needs to be maintained for an MSA. The size of the health plan deductible chosen depends upon the contribution made to the MSA. Funds not spent by the end of the year may be rolled over into the next year.

The final proposal is Flexible Spending Accounts (FSA’s); Congress started them in 1978. They permit workers to allow up to \$4,000 tax-free money to spend on health care expenses such as co-pays and deductibles that are not otherwise covered by insurance. MSA’s and FSA’s are very similar in the way they operate except with FSA’s the funds not used by the end of the year are not rolled over and must be returned. FSA’s do not allow workers to have control of their health care costs, which would need to be changed for this program to be effective.

Now that I have looked at some proposals that could help reduce the cost of health insurance for the self-employed I will talk about the plan that I feel would best accomplish this.

Cost is the reason most self-employed individuals do not have health insurance coverage. “Eight in ten small employers (84%) who did not offer health benefits cite the high cost of premiums as a very important factor in reaching that decision” (Rosenbaum, 01). Other reasons given for not offering health insurance were not being able to qualify for group rates and too many administrative burdens. Tax credits are a viable solution to begin addressing the insurance inequities in the tax code. President Bush’s administration is proposing \$89 million in new health care credits to make health insurance affordable for Americans who do not have employer-subsidized insurance.

Self-employed individuals pay 20 percent more for health insurance than do workers at larger businesses, according to NASE. A big reason for this difference is that self-employed individuals cannot deduct their health insurance premiums when calculating their 15.3 percent self-employment tax, which goes to Social Security and Medicare. “The businesses that can least afford it are paying disproportionately more for taxes,” NASE president Robert Hughes says.

Health insurance costs for other businesses can be fully deducted which is a major reason why many feel that the self-employed do not receive equal treatment when it comes to tax breaks and other growth incentives. When the employer is covering employee’s health insurance the costs are a deductible

business expense for the employer and the value of the benefits is excluded from the employee's taxable income. If the employee has to contribute towards the premiums they are generally not excluded from taxable income. Right now the self-employed may deduct from their taxable in a percentage of the amount they pay for health insurance coverage. "The deduction is not available to a self-employed person who is eligible for coverage under another subsidized employer plan, either directly or through a spouse" (Wilensky, 04). Less than a third of self-employed individuals are optimistic about conditions for their business, compared to two years ago. Most self-employed people get their health insurance coverage in the individual insurance market. The self-employed and the employees who do not have health insurance benefits must purchase their own insurance where coverage is most often expensive.

Several factors usually make individual insurance more expensive than group insurance. First, group insurance is priced according to the entire group of employees. In the individual market, each family or policyholder is basically a group in itself and there is no volume discount. A larger employer provides the insurance company many individuals with some being higher users and other having low utilization which balances out the cost for the insurance company. Insurance companies use cost sharing features such as deductibles, co-payments, coinsurance, and benefit limits to help keep the cost low for group insurance. The quality of group policies tends to be higher, as individual policies usually do not offer mental health, maternity leave, or prescription drug coverage. There are also more administrative costs with individual policies. It costs the insurance company more to market, underwrite, enroll, and administer single policies. The costs are reflected in the administrative load for individual policies. Another factor is that the cost of group insurance is excluded from a person's taxable income. "The employer receives a full tax break for the money spent on health benefits and dollar value of the benefit is not passed on to the employee as taxable income" (Gruber, Levitt, 00). This type of tax treatment is a hidden benefit for group insurance. The same treatment is not available in the individual market. The self-employed may deduct a portion up to 50 percent of what they spend for health insurance. This tax inequity is unfair for the self-employed.

Over 43 million people in America did not have health insurance in 2002 according to the Kaiser Foundation. As the number of uninsured continues to grow there is much debate among policymakers about tax credit proposals' impact on lowering health insurance costs. There are three different options that the tax credit proposal could take. Above the line deduction, insurance premiums could be deducted with this plan regardless of if they itemized other deductions. This tax plan would favor those with income in the higher tax brackets who generally have health insurance. Nonrefundable credits work by reducing the actual amount of tax paid instead of taxable income. It would offer a dollar subsidy for each dollar spent. The refundable credit plan is the one I

favor and support for the use with tax credits; I discuss the plan in the conclusion section of the paper.

President Bush's proposal is to create a refundable tax credit of up to 90 percent of the premium for non-group health insurance. The plan would involve a maximum credit of \$1,000 per adult and \$500 per child for up to 2 children in a family. Low-income individuals and families, which include income below \$15,000 for individuals and \$25,000 for families, would receive the 90 percent credit. The subsidies would then decline with income at \$30,000 for individuals and \$40,000 for single adults with dependents. You could claim the credit by part of the normal tax filling process or in advance at the time the insurance is bought.

For a tax credit proposal like this one a little over 10 million people would use it which includes about 4.5 percent of the population below age 65. According to Gruber about 3.1 million of the tax credit users would be from the previously uninsured with the rest being people who were already insured by an employer. While there may be over 10 million people eligible to use the proposed Bush tax credit including around 3 million previously uninsured people, it would provide insurance to only 1.8 million uninsured under the age of 65.

President Bush's tax credit proposal would also be designed to subsidize public programs such as Medicaid, and SCHIP. Tax credit-eligible people could buy coverage through Medicaid, or SCHIP managed care plans in states where these programs contract their coverage.

The main concerns regarding this tax credit proposal are the segment of population gaining insurance and people with employer sponsored insurance having it dropped. Under President Bush's tax credit proposal the average person gaining insurance would be younger and somewhat healthier than the uninsured population. The other impact of this proposal would be on people with employer-based coverage. With the new tax subsidies brought on by this proposal it would cost more for employers to offer coverage compared to the rates for non-group coverage, which would result in fewer employers offering health insurance. Some of these employees would have a hard time finding other health insurance as well because they would not want to pay for high premiums or they would be ineligible because of preexisting health problems.

Despite some of the flaws with President Bush's tax credit proposal, tax credits are still a viable way to help the self-employed afford health insurance. The tax credit policy just needs to be modified to provide some assistance that will better take care of the older and less healthy self-employed.

CONCLUSION

When considering a tax credit for individual coverage the policymakers must address these questions: who should be eligible for the subsidy? How large should the subsidy be, and should there be any adjustments for things like age, or geography? Should the subsidy be good for any kind of health insurance or should there be a minimum standard? For a tax credit to work well these questions need to be answered. Like many small business the self-employed face economic disadvantages and difficulties that make it harder for them to compete. Obtaining healthcare coverage is an area they face a disadvantage in because of their financial vulnerability. It is extremely costly for health insurance to be purchased in the individual market yet for many self-employed this is their only option.

Here are the following criteria that I believe are necessary to achieve a good health insurance tax credit system that will aid the self-employed for the long term. A refundable tax credit could exceed tax liability, and make the excess refundable to the taxpayer. With a refundable tax credit, an advance payment could be possible thus allowing the person to receive the credit over the course of the year instead of waiting for when they file.

Individuals and families with incomes below a specified threshold are the target population for the refundable tax credit. While tax credits are a great way to help make health insurance more affordable for the self-employed, I do not feel they should be limited to just the self-employed. Making tax credits available to everyone who meets the requirements is going to be the best way to decrease the uninsured. As a family's income level went up, the credit would become less and, for those at a certain income, even reach zero. Looking at statistics from 2002 shows that income levels will limit the population eligible for tax credits. "For 2002 the poverty income level guide was \$8,860 for a single person and \$18,100 for a family of four" (Fisher, 04). The numbers show that the poverty level is set low which would help a tax credit of this nature reach the people with the need for financial help. About one in four uninsured people would apply for a tax credit of this nature. Unlike with other tax proposals, I feel that an income-based phase-out of the tax credit plan is necessary. Having limits helps reduce the cost of the proposal. Setting limits involves assuming a cutoff point - in this case, income whereat people can afford health insurance. But who is to say that someone earning \$9,000 a year is more capable of affording health insurance than someone making \$8,500 per year? Unfortunately limits need to be set in order to keep the cost in check. The proposal should exclude Medicare, and Medicaid recipients. By excluding this population it would help prevent the shifting of people from the partially state funded programs to the tax credit which would be all federally funded.

"If a credit is not large enough to pay the entire cost of health insurance, not everyone who is eligible will actually obtain coverage" (Gruber, 04). While any tax credit will help lower the price of health insurance one of the problems is

figuring out how much needs to be lowered for people to pay? Elasticity of the tax credit needs to be examined by economists to figure out where to set the credit. What research does show is that higher-income people, the sick, and the elderly, are willing to pay more for premiums than the young and healthy. Research conducted by the NASE shows that in order to get 57 percent participation by people making \$15,000 a year, the amount the person would have to pay after the tax credit would be around \$150. This information demonstrates that in order to get the necessary participation to make an impact the financial contribution from the citizen needs to be minimal.

What low prices bring up is the question: how good is the coverage going to be? Everybody is going to have a different opinion on what good health insurance includes. For people relying on tax credits to provide affordable health insurance, the aim of the plan should be to protect the people from catastrophic losses, a low cost policy with high deductible would probably work best in this situation. Tax plans have failed in the past when the coverage did not offer quality insurance, so potential users did not participate. The government would need to set quality standards for the insurance policies if they were to be purchased using tax credits. While imposing standards may be controversial, there needs to be a system to certify the quality of health insurance plans. If participation rates in the tax credit plan are to low then most likely the people using the credit are going to be those with poor health. Utilization by members with only poor health will eventually lead to an increase in premiums since this group is using so many resources. On the other hand, insurance companies might try to offer few policy options to those using tax credits to save themselves money. Lawmakers need to require insurance companies to make some or all of their policies available to people using tax credits. The regulations should be made at the state level, which I feel would best fit the local insurance markets. The federal government could back up the states by requiring minimal standards. This would allow the states to go beyond federal requirements.

The price for health insurance premiums are different depending on what part of the country you live in. "The Council of Economic Advisers found that premiums for a family of four ranged from \$1,272 in Illinois, to \$9,675 in Boston" (Fisher, 04). This means that a fixed credit would cover different amounts of the premium depending on what part of the country you lived in. I feel in order to get the maximum utilization from the credit, a financial adjustment will need to be made depending on where a person lives. The adjustment can be based on a local index value based on cost of living.

Recipients of Medicare should not be allowed to participate in the tax credit program. However, age will affect tax credits. Older buyers using tax credits will end up paying higher premium prices. Insurance companies generally price the policy of a healthy old person at least twice that of a healthy young person. "A tax credit would leave the older buyer paying a much higher share of income

towards premiums than a younger buyer with the same income” (Gruber, Levitt, 00). The tax credit would be adjusted by age, but older participants would still pay higher premiums due to their high utilization. If age were not a factor, insurance companies would still end up setting the premiums high because older people are willing to pay more for insurance. High premiums would result in less participation by the uninsured who are usually younger people. The goal of this tax credit proposal is to help make coverage affordable for those in need so age adjustments are going to be applied.

The proposal should not include the Medicaid population, it should be budget neutral, and it should provide the maximum benefit for the most people. Under this type of system everyone eligible would get a tax credit based on income. A tax credit for policy purchases would be given for middle and high-income individuals. Low-income people could get a voucher from the government based on the previous year’s tax return. This voucher would allow people to purchase health insurance directly from the company of their choice.

Unlike other tax credit proposals this one would not cover those with employer provided health care. The reason for not offering the tax credit to those with employer sponsored health insurance is to help prevent shifts from employer coverage to tax credit subsidized non-group coverage.

Right now one of the advantages of employer sponsored health insurance is that they are offered tax subsidies and individuals are not. Offering a tax credit to people with employer coverage would reduce the advantage of employer’s providing coverage and make non-group coverage more attractive. If employees could find coverage for less using tax credits than the premiums they pay for employer provided insurance then everyone would drop their insurance through work. The shift of workers leaving employer coverage and using tax credits would put too much cost back on the government, resulting in cost being passed onto the public.

Tax credit values would follow this initially, if one’s income were less than \$6,500, the per person tax credit would be \$1,900, income between \$6,500 to \$14,500 then it would be \$1,250, and if your income were greater than \$14,500 then the tax credit would be \$750. These values are considered conservative and would be up for adjustments after seeing how the system operated.

Since the tax credit would be almost the same for everyone it would be easy for the federal government to implement. How the government implements the new tax credit will play a major role in deciding how many people use the subsidies. “The more complex the system, the longer it will take and more difficult it will be to obtain significant participation rates among the targeted populations” (Feldman, 00). Educating the public on the program is going to increase utilization. The public needs to have answers to questions such as who is eligible, how to receive the credit, and what type of coverage the credit can be used for. “Providing adequate information and communication about any new federal policy to encourage health insurance coverage is essential to achieving

significant participation” (Wilensky, 04). The government will need to launch an information campaign that talks about the highlights of the program along with the importance of having health insurance.

Using the existing tax filing system is probably the easiest way to provide the tax credit. Eligibility status would be determined in advanced based off of their expected income for the year along with any other criteria for the credits. This proposal would allow the people to receive the reimbursement for their health insurance by claiming the credit when filing their tax returns. This proposal has no complex formulas to figure out the credit. People would report the use of the credit on their income tax returns. The IRS would process the credit as they would any other tax benefit and treat it as part of the auditing process. This program should not add any additional administrative cost to the government.

The government would not give the people money to pay for their insurance. Instead, once qualified, the person would receive some form of voucher to give the insurer. The insurance company would then be reimbursed by the government.

“A tax credit equalizes the tax treatment of health insurance across all types of health insurance coverage. Providing a tax credit to all Americans would allow consumers to choose the type of health plan that best meets their family’s needs” (Gruber, Levitt, 00). Unlike other tax credit proposals this one would benefit the self-employed and still be attractive to employers. Employers, especially ones with a lot of minimum wage employees, will still be able to hire hard workers and those employees will be able to afford health insurance. The self-employed and the working uninsured could obtain health insurance without having to give up all of their tax advantages to buy healthcare.

Not seeking healthcare when it is necessary leads to poor healthcare outcomes. The uninsured self-employed reported having poor health almost twice as often as those with employee-sponsored healthcare. “Uninsured self-employed were far less likely to visit a doctor than were employees with employer sponsored health insurance” (Rosenbaum, 01). The uninsured have an increased risk of death compared to the insured. Health insurance increases medical care use by about 50 percent. When you look at the results of not having health insurance and take into consideration the impact of the self-employed on our country’s economy there is a need to provide help for the self-employed. Tax credits are the best option for helping provide affordable, quality health care among the self-employed. A health insurance tax credit like the one proposed is a fair way to even the playing field for this country’s self-employed. The tax credit is easy to calculate and simple to implement. A federal tax credit would strengthen and revitalize the American Self-Employed.

Adam Buchalski is assistant athletic trainer at Grand Valley State University. He holds a Bachelors of Science degree with emphasis in athletic training from the University of Michigan. In April of 2006 graduated with a Masters of Healthcare Administration degree from Grand Valley State University.

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