Research

Primer: The Medical Device Tax

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In 2010 Congress passed the Affordable Care Act (ACA), which included numerous taxing and spending provisions. Most of the taxes were on individuals, employers, and insurers, aimed at encouraging competitive prices and universal participation in the insurance market. Some revenue, however, was to be raised through three explicit excise taxes. One of these taxes (on indoor tanning) was specifically intended to discourage risky behavior. Another, a fee paid by insurers for the Patient Centered Outcomes Research Institute, is ostensibly intended to help insurers make better payment choices, though in practice it is used to help fund insurance subsidy payments.[1] The third excise tax, on the other hand, serves no traditional purpose, but instead targets the medical device industry simply to raise revenue to support the ACA.[2] Proponents of the tax have tried to justify it by pointing to the increased demand for devices that they claim could result from other provisions of the ACA.[3] But this logic is widely considered flawed and today even many Democrats are signaling their support for a repeal of the medical device tax.

The Medical Device Tax

The medical device tax, which went into effect on January 1, 2013, is a 2.3 percent excise tax on net revenue for all manufacturers and importers of taxable medical devices.[4] All manufacturers and importers must file quarterly reports on their revenues. The Congressional Research Service (CRS) estimates that the administrative and compliance costs alone may create a drag on the industry.[5]

About half of all devices manufactured in the US are exempt from the tax because they are ultimately sold to other manufacturers for use as parts for more complex devices, or exported (the medical device industry has a surplus of American exports).[6] However, 100 percent of products sold in the US are still subject to the tax.

The tax is levied on net revenue, not profit. This means that a device manufacturer that has $1m revenue after allowable expenses, and $200,000 profit, will now pay an additional $23,000 tax. This tax will either mean an 11.5 percent cut in profit, or a price increase on its products.[7] This is a generous example: only the top 30 American manufacturing firms generate anything near a 20 percent profit margin; in fact, discounting those top firms, the remaining firms, including many start-ups, together average a net annual loss.[8]

How the Industry Will Pay for This Tax

The Obama Administration has referred to the ACA as a “windfall” for pharmaceutical and medical device manufacturers.[9] The idea behind this statement is that under the individual mandate, many previously uninsured individuals will now be consuming more health services than in the past; but this is not necessarily the case. The reality is that more people are now insured, but not necessarily purchasing more medical devices.[10] In fact, as CRS noted, demand for medical devices is relatively inelastic.[11] Medicare beneficiaries make up the vast majority of consumers of medical devices, and any increase in sales due to the ACA is negligible; but when the cost of the medical device tax is passed on to Medicare, the effect is a disguised cut to Medicare. Furthermore, most purchasers of medical devices are hospitals or physicians, not consumers, who are individually unlikely to recognize price inflation since the device is usually billed for as part of a bundled service: no one will buy just a pace maker, but rather the pace maker is sold as part of the surgery to install it. [12]

Instead of recovering the excise tax through increased sales, device manufacturers are forced to look for new ways to deal with this increase in costs. According to the Advanced Medical Technology Association (AdvaMed), the excise tax has caused the loss of 14,000 high-skilled jobs. Additionally, related slowing in industry growth caused the loss of another 19,000 skilled jobs, and the loss of as many as 132,000 jobs in support industries.[13]

Forty-one percent of all medical devices in the world are manufactured by one of the top-ten firms,[14] yet there are over 7,000 device manufacturing firms in the US alone, 80 percent of which have 50 or fewer employees. [15] In fact, the average annual net income for the top 30 US firms in 2011 increased 22 percent, while the rest of the device industry (6,000+ firms) had a net loss of 186 percent.[16] Yet the device tax will apply to all device manufacturers, including those who fail to net any profit in a given year, and all these companies will have to find a way to recover these losses.

Competition is tightest among producers of conventional medical products, such as needles, catheters, or surgical gloves.[17] Because competition will not allow manufacturers to pass on the full cost of the tax to consumers for these products, in these parts of the market, the tax will come largely from revenues.

Most large firms manufacture conventional products as well as specialty products with high profit margins, such as pace makers, artificial joints, etc.[18] These firms will be able to recover lost profits from conventional products by raising prices for specialty products (shifting the cost onto sicker individuals). Smaller manufacturing firms, however, are unlikely to have this option and will be unable to shift costs as easily. Though many of these firms manufacture specialty products with higher profit margins, even a 2.3 percent cut in profits could dissuade investment in research and development of innovative technologies.[19]

How Congress is Treating the Medical Device Tax

During the 16 day federal government shutdown in 2013, one of the sticking points for Republicans was repeal of the medical device tax.[20] Though the device tax survived, in the year following, it turned out that many Democrats as well as Republicans were of the persuasion that the medical device tax does more harm than good. In 2013, the Senate held a largely symbolic vote on a medical device tax repeal bill sponsored by Senator Orrin Hatch. The measure passed 79-20 with 33 Democrats joining Republicans in favor of repeal.[21]

The medical device tax is an example of poorly devised tax policy. In fact, in his press conference the morning after Republicans achieved majorities in both Houses of Congress, even President Obama indicated that he would be open to repealing this tax.[22]

[1] IRS Affordable Care Act Tax Provisions (Dec. 29, 2014), http://www.irs.gov/Affordable-Care-Act/Affordable-Care-Act-Tax-Provisions.