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## Excise Tax on Medical Devices Should Not Be Repealed Industry Lobbyists Distort Tax's Impact

By Paul N. Van de Water

House Republicans have reportedly decided to attach to the Senate-passed funding bill for fiscal year 2014 a provision to repeal the 2.3-percent excise tax on medical devices that policymakers enacted in 2010 to help pay for health reform. The excise tax is sound, however, and the arguments against the tax don't withstand scrutiny.

- **The tax does not single out the medical device industry for unfair treatment.** The excise tax is one of several new levies on sectors that will gain business due to health reform. The expansion of health coverage will increase the demand for medical devices and could offset the effect of the tax.
- **The tax will not cause manufacturers to shift production overseas.** The tax applies equally to imported and domestically produced devices, and devices produced in the United States for export are tax-exempt.
- **The tax will have little effect on innovation in the medical device industry.** To the contrary, health reform may well spur medical device innovation by promoting more cost-effective ways of delivering care.

Repealing the excise tax would cost more than \$30 billion over the 2014-2023 period.<sup>1</sup> Repealing the tax would undercut health reform in at least two ways. Pay-as-you-go procedures would require Congress to offset the cost of repeal by increasing other taxes or reducing spending; one Republican target would be the provisions of the Affordable Care Act (ACA) that expand health coverage. Also, repealing the tax would encourage efforts to repeal other revenue-raising provisions of the ACA, which in turn would either require still more painful offsets or increase the budget deficit (if Congress failed to offset the cost).

The industry's lobbying campaign against the medical device tax is based on misinformation and exaggeration, as a number of industry executives and analysts confirm. For example, Martin Rothenberg, head of a device manufacturer in upstate New York, calls claims that the tax would

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<sup>1</sup> Joint Committee on Taxation (JCT), *Description of H.R. 436, The "Protect Medical Innovation Act of 2011,"* Publication JCX-45-12, May 29, 2012. JCT estimated that repealing the tax would cost \$29 billion over the 2013-2022 period.

cause layoffs and outsourcing “nonsense.” The tax, he writes, will add little to the price of a new device that his firm is developing. “If our new device proves effective and we market it effectively, this small increase in cost will have zero effect on sales. It would surely not lead us to lay off employees or shift to overseas production.”<sup>2</sup> Michael Boyle, founder of a Massachusetts firm that makes diagnostic equipment, insists that the device tax is “not a job killer. It would never stop a responsible manager from hiring people when it’s time to grow the business.”<sup>3</sup>

## The Excise Tax on Medical Devices

Congress carefully designed the ACA so that it will not add to the budget deficit. To help pay for the expansion of health coverage to 25 million uninsured Americans, the ACA either reduces Medicare payments or increases taxes for a wide range of industries that will benefit from health reform, including hospitals, home health agencies, clinical laboratories, health insurance providers, drug companies, and manufacturers of medical devices.

The ACA imposes a 2.3-percent excise tax on the sale of any taxable medical device by the manufacturer or importer of the device starting in 2013. The tax does not apply to eyeglasses, contact lenses, hearing aids, wheelchairs, or any other medical device that the public generally buys at retail for individual use.<sup>4</sup> Sales for further manufacture or for export are also tax-exempt.<sup>5</sup> The Internal Revenue Service (IRS) published proposed regulations in February 2012 and final regulations in December providing detailed guidance on how the tax will be applied.<sup>6</sup> The IRS has also issued interim guidance for determining the price of a taxable device and providing transition relief from penalties for failure to pay the tax.<sup>7</sup>

Lawmakers initially considered a higher tax, but the medical device industry succeeded during the health reform debate in halving the amount of revenue that a fee or tax on devices would raise. Since the excise tax was enacted, lobbyists for the industry have been pressing for its delay or repeal. Last year the House passed H.R. 436, which would have repealed the tax, and the Senate this year approved a non-binding resolution supporting repeal.

Medical devices encompass an extremely wide range of products, such as surgical gloves, dental instruments, coronary stents, artificial knees and hips, defibrillators, cardiac pacemakers, irradiation equipment, and advanced imaging technology. The U.S. medical device industry has estimated total

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<sup>2</sup> Martin Rothenberg, “Numbers show ACA not responsible for layoffs,” *Syracuse Post-Standard*, September 25, 2012, [http://blog.syracuse.com/opinion/2012/09/numbers\\_show\\_aca\\_not\\_responsib.html](http://blog.syracuse.com/opinion/2012/09/numbers_show_aca_not_responsib.html).

<sup>3</sup> Alec MacGillis, “Um, About That Medical Device Tax,” *The New Republic*, September 28, 2012.

<sup>4</sup> The excise tax is established by section 1405 of the Health Care and Education Reconciliation Act of 2010 (Public Law 111-152), which effectively substituted for section 9009 of the Patient Protection and Affordable Care Act of 2010 (Public Law 111-148).

<sup>5</sup> The excise tax is one of several manufacturers’ excise taxes included in subtitle D, chapter 32, of the Internal Revenue Code. Section 4221 of the Code provides that sales for further manufacture or export are exempt from these excises.

<sup>6</sup> *Federal Register*, February 7, 2012, pp. 6028-38; December 7, 2012, pp. 72924-39.

<sup>7</sup> Internal Revenue Service, *Notice 2012-77, Interim Guidance and Request for Comments; Medical Device Excise Tax; Manufacturers Excise Taxes; Constructive Sale Price; Deposit Penalties*, <http://www.irs.gov/pub/irs-drop/n-12-77.pdf>.

sales of \$106 billion to \$116 billion a year.<sup>8</sup> A few large firms account for the lion's share of this revenue. For example, Johnson and Johnson's worldwide sales of medical devices and diagnostics totaled \$27 billion in 2012; the firm had total sales (on both medical devices and other products) of \$67 billion, on which it earned profits of nearly \$11 billion.<sup>9</sup> Medtronic had \$16 billion in sales and profits of nearly \$4 billion in its 2012 fiscal year.<sup>10</sup> One trade group has estimated that the ten largest medical device makers will account for 86 percent of the sales of covered medical devices and hence pay 86 percent of the receipts from the excise tax.<sup>11</sup>

## Tax Will Not Shift Employment Offshore

Despite claims to the contrary, the excise tax creates no incentive whatsoever for medical device manufacturers to move production overseas. The tax applies to imported as well as domestically produced devices. Thus, sales of medical devices in the United States will be equally subject to the tax whether they are produced here or abroad, and the tax will not make imported devices any more attractive to domestic purchasers.

In addition, devices produced in the United States for export are exempt from the tax, so it will not reduce the competitiveness of U.S.-made devices in international markets. Making a tax-free sale for export is straightforward, and the administrative burden of securing an exemption is small. The device manufacturer and the U.S. exporter will register with the IRS (foreign purchasers of articles for export need not register), and the U.S. exporter must simply provide its registration number to the manufacturer and certify that the devices will be exported.<sup>12</sup>

A much-cited 2011 study financed by AdvaMed, an industry trade association, alleges that the tax would cause 10 percent of device manufacturing to move offshore, leading to the loss of 43,000 U.S. jobs.<sup>13</sup> Analysis by Bloomberg Government, however, finds that the study "is not credible." Its assumptions, Bloomberg concludes, "conflict with economic research, overstate companies' incentives to move jobs offshore, and ignore the positive effect of new demand created by the [health reform] law."<sup>14</sup>

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<sup>8</sup> Christopher Flavelle, *Medical Device Industry Overstates Tax Impact*, Bloomberg Government Study, February 9, 2012.

<sup>9</sup> *Johnson & Johnson Reports 2012 Fourth-Quarter and Full-Year Results*, January 22, 2013, <http://www.investor.jnj.com/releasedetail.cfm?ReleaseID=734718>.

<sup>10</sup> Medtronic, Inc., *2012 Annual Report*, p. 28.

<sup>11</sup> Staff of Massachusetts Medical Devices Journal, "Medical device tax would mostly hit the biggest firms," *MedCity News*, March 24, 2010, <http://www.medcitynews.com/2010/03/medical-device-tax-would-mostly-target-the-biggest-companies/>.

<sup>12</sup> *Federal Register*, February 7, 2012, p. 6033.

<sup>13</sup> Diana Furchtgott-Roth and Harold Furchtgott-Roth, *Employment Effects of the New Excise Tax on the Medical Device Industry*, Advanced Medical Technology Association, September 2011, <http://www.advamed.org/NR/rdonlyres/27ADDF3E-292D-4DFC-B4ED-B01E93E6D5AD/0/090711EmploymentEffectofTaxonMedicalDeviceIndustryFINAL.pdf>.

<sup>14</sup> Christopher Flavelle, "How Much Will the Medical Device Tax Hurt?," *Bloomberg Businessweek*, March 22, 2012, <http://www.businessweek.com/printer/articles/14874-how-much-will-the-medical-device-tax-hurt>.

AdvaMed commissioned another study in 2012, but it is not credible either. AdvaMed hired the consulting firm Battelle to assess the effect of a “hypothetical economic event” that results in a \$3 billion annual decline in the medical device industry.<sup>15</sup> Battelle used what economists call an input-output model to estimate that this event would cause a loss of 10,000 jobs in the medical device industry and 29,000 jobs in other sectors of the economy. But there is no reason to think that the tax will cause a \$3 billion drop in the sale of devices. Moreover, input-output models are not an appropriate way to analyze how changes in a given industry affect the economy as a whole.<sup>16</sup>

As *The Economist* magazine states, the effect of the excise tax on the medical device industry will be “trivial compared with other shifts,” such as “scandals, recalls, stingy customers, [and] anxious regulators,” all of which have left the industry in a “rut.”<sup>17</sup> For example, device-maker Stryker Corporation revealed plans in 2011 to lay off 1,000 workers, or 5 percent of its workforce, and implement other restructuring activities. In a press release announcing the changes, Stryker cited the excise tax but also stated that the restructuring aims “to allow for continued investment in strategic areas and drive growth despite the ongoing challenging economic environment and market slowdown in elective procedures.”<sup>18</sup> Critics of the excise tax, however, rushed to ascribe the layoffs to the tax.<sup>19</sup> When the *Columbus Dispatch* investigated similar claims in Ohio, home to many small device manufacturers, it found that “industry officials could not cite an example in Ohio of a company that has cut jobs or put growth plans on hold in anticipation of the tax.”<sup>20</sup>

In fact, health reform may, on balance, benefit the medical device industry and boost its sales. By extending health coverage to 25 million more Americans, or by nearly 10 percent, the Affordable Care Act will increase the demand for medical devices and the revenue of device manufacturers. As the industry notes, older patients, who use a disproportionate number of medical devices, already have coverage through Medicare. However, the substantial expansion of health coverage will increase the number of elective medical procedures performed on those who were previously uninsured and, in turn, the use of medical devices. Bloomberg Government finds that the effect of the tax “could be offset by demand from millions of new customers.”<sup>21</sup>

## Tax Will Have Little Effect on Innovation

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<sup>15</sup> Battelle, *The Economic Impact of the U.S. Advanced Medical Technology Industry*, March 2012, <http://www.advamed.org/NR/rdonlyres/6C514FB6-8497-475C-84DC-7872A9DDBADC/0/BattelleFinalAdvaMedEconomicImpactReportMarch2012.pdf>.

<sup>16</sup> Paul N. Van de Water, “More Bogus Economics from the Medical Device Industry,” *Off the Charts Blog*, March 30, 2012, <http://www.offthechartsblog.org/more-bogus-economics-from-the-medical-device-industry/>.

<sup>17</sup> “Left to their own devices: Medtronic and the woes of America’s medical-technology industry,” *The Economist*, September 10, 2011, <http://www.economist.com/node/21528644>.

<sup>18</sup> Stryker Corporation, “Stryker Announces Actions to Drive Over \$100 Million in Annual Productivity Gains,” November 10, 2011, <http://phx.corporate-ir.net/phoenix.zhtml?c=118965&p=irol-newsArticle&ID=1629222&highlight>.

<sup>19</sup> Han Zhong, *Medical Device Excise Tax Claims Its First Victims*, American Action Forum, November 16, 2011.

<sup>20</sup> Ben Southerly, “Medical-device makers fight tax,” *The Columbus Dispatch*, May 15, 2012, <http://www.dispatch.com/content/stories/local/2012/05/15/medical-device-makers-fight-tax.html>.

<sup>21</sup> Flavelle, “How Much Will the Medical Device Tax Hurt?”

The excise tax also will likely have very little effect on innovation in the medical device industry, despite claims to the contrary. The consulting firm PricewaterhouseCoopers has identified five pillars of medical technology innovation: financial incentives, human and physical resources, a favorable regulatory climate, demanding and price-insensitive patients, and a supportive investment community.<sup>22</sup> Each pillar comprises more than a dozen separate factors, and the tax rate is just one of the many factors affecting financial incentives.

The rate of innovation in medical technology has slowed in recent years for reasons entirely unrelated to the excise tax. “Like Big Pharma, which introduced many ‘me too’ drugs,” writes *The Economist*, “device companies have sustained themselves by making small improvements to existing products. Spending on R&D has so far failed to yield many truly innovative devices.”

Health reform may well spur medical-device innovation by promoting more cost-effective ways of delivering care. As PricewaterhouseCoopers observes:

Government pressure to lower healthcare costs could . . . forc[e] developed nations to turn to innovative technology to achieve better results at lower costs. In the United States, for example, the [ACA] calls for reduced annual payment updates for most Medicare services, substantial cuts to managed care plan payments, and the creation of an Independent Payment Advisory Board. These are small steps in what will be a prolonged and complex effort by Western nations to rein in healthcare costs.<sup>23</sup>

A recent article in *The New York Times* provides further evidence that the impact of the tax will be minimal.<sup>24</sup> The article tells the story of a Colorado man whose health insurance wouldn’t cover his hip replacement because it was considered a pre-existing condition. His local hospital quoted him an unaffordable price of more than \$78,000. So he had his hip replaced in Belgium, where it cost him a grand total of \$13,660.

The artificial hip itself is one component of the overall price of the procedure. While an artificial hip costs about \$350 to produce in the United States, the *Times* reports, device manufacturers charge vastly more. The Belgian hospital paid about \$4,000, and American hospitals typically pay over \$8,000 for the same model.

The *Times* also reveals that three major manufacturers of artificial hips and other joints sold more than \$1 billion of joint implants in 2011 but spent only 5 percent of those revenues on research and development (R&D). At the same time, each of these firms paid their CEOs over \$8 million. Clearly, this segment of the medical device industry can easily absorb a 2.3-percent tax without raising prices or cutting R&D.

## **Tax Will Have Minimal Effect on Consumers**

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<sup>22</sup> PricewaterhouseCoopers (PwC), *Medical Technology Innovation Scorecard: The Race for Global Leadership*, January 2011.

<sup>23</sup> PwC, p. 12.

<sup>24</sup> Elisabeth Rosenthal, “In Need of a New Hip, but Priced Out of the U.S.,” *New York Times*, August 3, 2013, [http://www.nytimes.com/2013/08/04/health/for-medical-tourists-simple-math.html?hpw&\\_r=3&\\_](http://www.nytimes.com/2013/08/04/health/for-medical-tourists-simple-math.html?hpw&_r=3&_)

The effect of the excise tax on consumers' costs for health care and health insurance will be minimal and will be swamped by other factors. Spending on taxable medical devices represents less than 1 percent of total personal health expenditures, so a small increase in their price would have an almost imperceptible effect on health insurance premiums.

Device manufacturers generally do not hold enough market power to pass on the entire excise tax to consumers through higher prices. For some common medical devices (for example, heart valves and hip and knee replacement parts), buyers have several available alternatives and can negotiate for a favorable price. For other products, manufacturers may not be able to pass on the full tax to consumers because treatment of the health condition is elective or physicians can select other treatment options.<sup>25</sup>

Taking all of its provisions into account, health reform will modestly reduce the cost of health insurance. The Congressional Budget Office estimates that the ACA will reduce premiums for employers with more than 50 workers — which account for 70 percent of the total insurance market — by up to 3 percent by 2016. For small employers, the estimated change in premiums ranges from an increase of 1 percent to a reduction of 2 percent.<sup>26</sup>

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<sup>25</sup> Personal communication from Dr. Rena Conti, assistant professor of health policy and economics, University of Chicago.

<sup>26</sup> Congressional Budget Office, *An Analysis of Health Insurance Premiums Under the Patient Protection and Affordable Care Act*, November 30, 2009, <http://www.cbo.gov/ftpdocs/107xx/doc10781/11-30-Premiums.pdf>.