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The Benefits from Repealing the Medical Device Tax

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Introduction

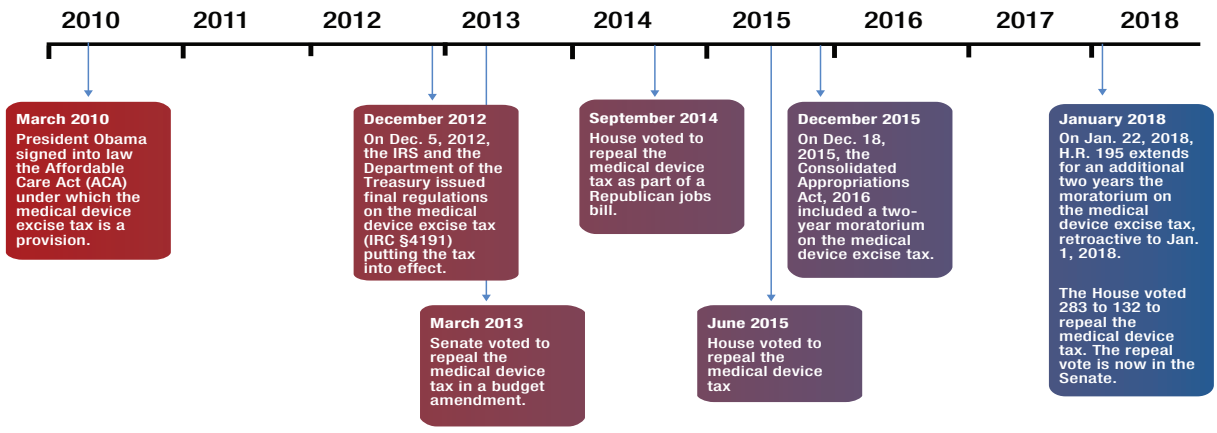
The medical device tax is one of several taxes created by the Affordable Care Act (ACA, aka Obamacare), which was signed into law on March 23, 2010. It is a 2.3 percent tax on a broad range of medical devices and products including pacemakers, advanced imaging technology (CT scan, MRI and ultrasound equipment), artificial joints, surgical gloves, and dental instruments. Eyeglasses, contact lenses, hearing aids, wheelchairs, or other devices that the public generally buys for individual use were explicitly exempted from the tax. Further, the tax is applied to both imported and domestically produced devices, and devices produced in the U.S. for export are tax-exempt. Manufacturers, producers, or importers of the medical device are responsible for directly paying the 2.3 percent tax.

Like all of the ACA tax increases, proponents claimed that the medical device tax was necessary in order to cover the increased health care expenditures associated with the ACA. However, the medical device tax was never an economically sound policy.

In recognition of the medical device tax's many flaws, Congress has twice implemented a moratorium that suspended the tax. While the moratorium is a welcome reprieve from the tax's pernicious effects, it is only temporary. Ideally, Congress should repeal this tax to eliminate the uncertainty surrounding its possible re-imposition.

Before outlining the medical tax's flaws, it is useful to understand its legislative history, which is summarized in Figure 1. Figure 1 presents a timeline of the medical device tax's key legislative and regulatory milestones.

Figure 1
Timeline of the Medical Device Tax's Major Legislative and Regulatory Milestones



Following the authorization of the medical device tax upon passage of the ACA in March 2010, the next important milestone occurred on December 5, 2012 when the IRS and the Department of the Treasury issued final regulations on the medical device excise tax (IRC §4191). With the issuance of these final regulations, the medical device tax became effective as of January 1, 2013.

Almost immediately upon becoming effective, congressional efforts to repeal the tax began. And, on three separate occasions either the Senate or the House of Representatives voted to repeal the tax: The Senate in March 2013 as part of a budget amendment; the House in September 2014 as part of a Republican jobs bill; and the House, once again, passed H.R. 160, the Protect Medical Innovation Act in June 2015. While these repeal efforts were never successful, a two-year moratorium on the medical device excise tax was passed by Congress on December 18, 2015, which became effective January 1, 2016. On Jan. 22, 2018, H.R. 195 extended the moratorium for an additional two years, retroactive to January 1, 2018. Following the moratorium's extension, the House also passed, yet again, legislation to repeal the medical device tax on July 24, 2018. This measure is under consideration in the Senate as of October 2018.

This volatile history indicates that bipartisan majorities in Congress have apparently experienced *buyer's remorse* with respect to the medical device tax. Rightly so. The medical device tax is fundamentally flawed by design, and, consequently, should never have been implemented. This paper overviews the medical device tax's fundamental flaws, which include violating the principles of a sound tax system, imposing unnecessary costs on the U.S. economy, and raising overall health care spending without increasing overall health care quality (contradicting the ACA's stated policy goal of "bending the health care cost curve").

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To demonstrate these flaws, the next section describes the widely accepted principles of a sound tax system, illustrates how the medical device tax violates these widely accepted principles, and details the expected economic consequences. The medical device tax was in effect between 2012 and 2015, so there is also an actual record of its results that can confirm whether the expected theoretical consequences occurred in practice. These results, which are reviewed next, illustrate that the actual empirical record is consistent with the theoretical expectations – the medical device tax increased the cost of medical devices, decreased medical innovation, and led to industry job losses.

In light of these large economic costs, the study's conclusion argues that passing a series of moratoriums is insufficient, the optimal policy permanently repeals the medical device tax. Permanently repealing the tax eliminates the negative consequences from the tax today and creates policy certainty which will encourage greater investment and innovation in the future.

Taxing Medical Devices Is Unsound Tax Policy

In order to comprehend the impact from taxes it is necessary to understand how taxes impact economic incentives. The incentive to engage in economic activities is based on people's after-tax return on wages and salaries and their after-tax return on investments. Tax increases reduce the after-tax return on economic activities and are, consequently, a disincentive to engaging in work, saving, and investment. Tax reductions increase the after-tax return on economic activities and, consequently, increase the incentive to work, save, and invest.

While this logic applies to all taxes, the disincentive effects from all taxes are not equal. Some taxes impose larger negative incentives on the economy than others. Efficient tax systems recognize these incentive impacts and implement the least incentive distorting taxes as possible.

Notwithstanding the partisan rancor, there is actually widespread agreement with respect to several core principles to which efficient tax systems should adhere – whether the tax system is at the state or federal level.

> **"Efficient tax systems recognize these incentive impacts and implement the least incentive distorting taxes as possible."**

For example, when discussing state tax systems, the Institute on Taxation and Economic Policy (ITEP), which generally favors liberal economic policies, states that "almost everyone would agree that advocates of tax reform should keep each of these principles [equity, adequacy, simplicity, exportability, and neutrality] in mind as they seek to improve their state's tax system."[1] The American Legislative Exchange Council (ALEC), which generally favors free-market economic policies, advocates for the guiding tax principles of: simplicity, transparency, economic neutrality, equity and fairness, complementary, competitiveness, and reliability.[2]

Non-partisan organizations also concur with these principles. For example, the Tax Foundation claims that principles of sound taxation include: transparency, neutrality, simplicity, stability, no retroactivity, complementary, and transparency (the Tax Foundation also stated that an efficient tax system imposes the lowest possible tax rate on the broadest possible tax base).[3] Similarly, the National Conference of State Legislatures (NCSL) has stated that the principles for a high-quality tax system include: reliability (including stability, certainty, and sufficiency), equity, balanced revenue sources, easy compliance and administration, complementary, economic neutrality, and accountability.[4]

When comparing these lists there are important differences and even within the similarities, disagreements will arise – most notably over the definition of what is an "equitable" tax, which is an inherently subjective concept. Despite these differences and disagreements there are several core tax principles that groups from the left, right, and center all agree.

Perhaps most important with respect to this analysis, the medical device tax violates several of these commonly agreed upon tax principles including the concepts of neutrality, simplicity, consistency, and

transparency.[5] A fifth principle that naturally follows is the importance of avoiding double taxation. Double taxing an activity violates these other core tax principles, which is important to mention because the medical device tax violates this principle as well.

Neutrality

Tax neutrality (sometimes referred to as tax efficiency) refers to an unattainable ideal that taxes do not alter any economic incentives or decision, unless such altered incentives were explicitly desired. Simply put, tax neutrality means that taxes should avoid picking winners and losers. Tax neutrality is important because economic growth is best promoted when investors undertake projects based on their economic merits, not based on minimizing their tax liabilities. Similarly, people's economic well-being is best promoted when they base their decisions to work, save, and consume on their personal preferences, not based on the tax consequences.

> **"Tax neutrality is important because economic growth is best promoted when investors undertake projects based on their economic merits, not based on minimizing their tax liabilities."**

Neutral taxes typically result from ensuring the tax is levied on the broadest possible tax base since narrow tax bases pick economic winners and losers by definition – those products lucky enough to avoid the tax win, while those products unlucky enough to bear the brunt of the tax lose. Inefficiently narrow taxes also necessitate higher marginal tax rates that diminish overall economic incentives. Consequently, ensuring a broad tax base is, perhaps, the most important means for ensuring the desired end (the most economically neutral tax).

Simplicity

The principle of tax simplicity means that taxes should be as easy for taxpayers to comply with as possible, and as simple as possible for the government to administer. Simple taxes impose minimal direct costs on taxpayers when complying and require fewer outlays by the government to administer.

In contrast to simple taxes, it is difficult for taxpayers to comply with complex taxes, and complex taxes create confusion for taxpayers regarding how much to pay, or whether the tax is applicable or not. Complex taxes are also costly for the government to administer and enable inequitable treatment across similar taxpayers.

When taxes violate the simplicity principle, resources are unnecessarily diverted away from productivity enhancing activities toward tax administration and compliance activities. Efforts by businesses that could be devoted toward innovating or better serving customers are spent complying with the tax. Consumers must devote time to tax compliance rather than spending time with their families or pursuing their interests. The result is slower income growth and lower overall economic welfare.

Consistency

Ideally, taxes should be applied consistently over time and across similar economic activities. When taxes are applied consistently, taxpayers know, with certainty, how their actions will impact their future tax liabilities. Take for example a low-rate, broad-based tax on consumption. If the rate is rarely changed, then both producers and consumers know what the tax implications are from selling or buying goods and services today, tomorrow, and next year.

In contrast to a consistent tax, taxes can be structured such that they are not implemented consistently, or Congress can constantly tinker with a tax, making random and unpredictable tax changes. Such tax inconsistency materially impacts the plans of businesses and individuals; creates arbitrary economic winners and losers based on the tax laws, not on the economic merits; and, dis-incents people from engaging in activities that are either currently taxed or could be taxed soon.

Everything else equal, taxes that are inherently more consistent, or applied with greater consistency, will promote economic growth better than taxes that are either inherently inconsistent, or applied inconsistently.

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Transparency

Tax transparency is essential for both legitimacy and for ensuring that the other desired tax principles are not eroded over time. While not discussed here, take equity concerns as an example. Regardless of one’s definition of tax equity, it is self-evident that ensuring a tax is transparent makes it easier to determine how that tax impacts different groups and who is, ultimately, bearing the burden of the tax. Alternatively, it is harder to ensure that equity considerations are addressed when taxes are hidden and vague.

Hidden taxes are also subject to constant changes, high burdens, and unwarranted loopholes carved out for well-connected individuals and industries. Thus, hidden taxes will often be applied inconsistently and violate the principle of tax neutrality.

Avoid Double Taxation

Double taxing income, assets, or consumer purchases violates three of the commonly agreed upon tax principles. Systems that double tax the same activity are complex, difficult to comprehend, and biases an economy away from the activity that is being taxed multiple times. Thus, just like a hidden tax, applying multiple taxes to the same economic activity is a means for violating the core tax principles of economic neutrality, simplicity, and consistency.

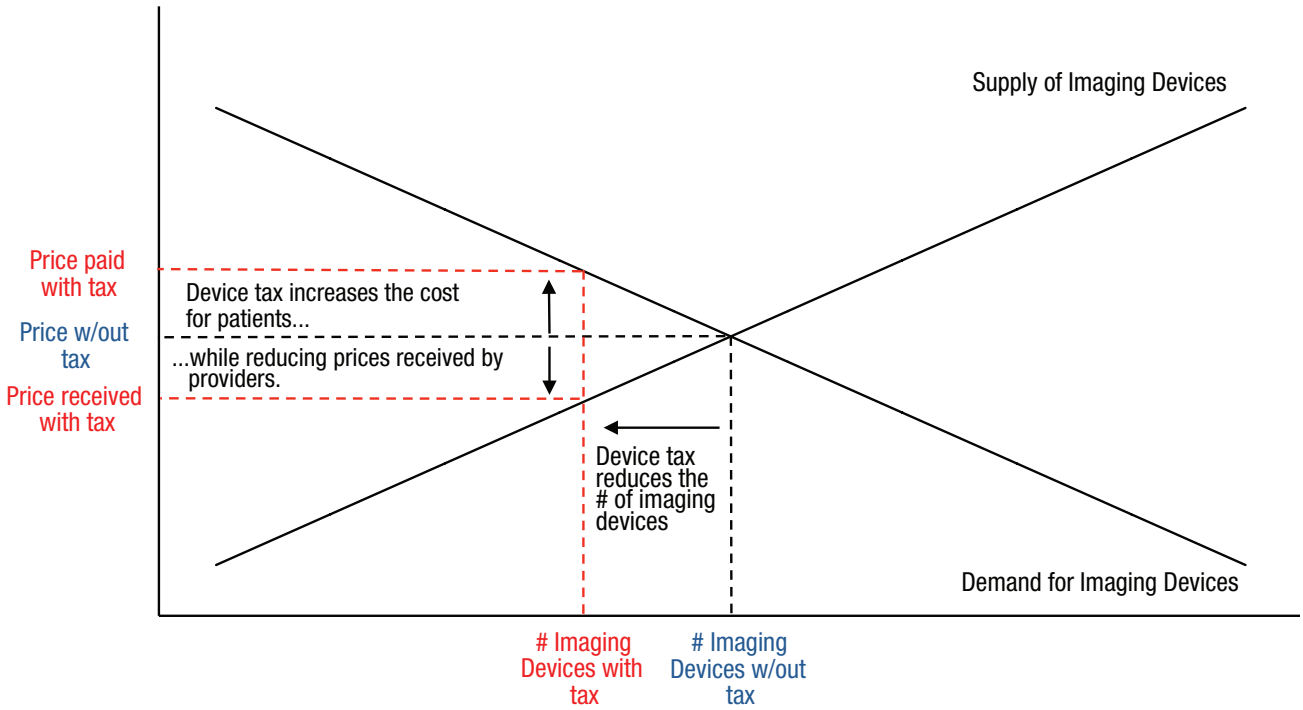
The Medical Device Tax's Principle Violations

There are several ways that the medical device tax violates these widely accepted tax principles. However, before illustrating how the medical device tax violates these principles, it is helpful to review the basic economics of the medical device tax.

Generally speaking, excise taxes such as the medical device tax create unwanted inefficiencies. Perhaps more important, the typical arguments used to justify the imposition of an excise tax does not apply to the medical device tax. Specifically, excise tax proponents often justify these taxes as a means for discouraging the externalities created by the product in question. Regardless of this argument's merits, it clearly does not apply to medical devices. Further, although the goal of the tax is not to discourage the use of medical devices, that is its ultimate impact. Take imaging technologies as the example.

Imaging technologies help physicians detect diseases in their earliest stages when they are most treatable. Clearly, the tax should not discourage greater use of these crucial medical technologies nor increase their price. Yet, introductory economics teaches that this is precisely the expected result from the imposition of the medical device tax, see Figure 2. Figure 2 is a simple supply and demand diagram straight out of any introductory economics textbook. It demonstrates what happens to any market, in this case the market for imaging technology, when a tax is imposed.

Figure 2
The Supply and Demand Basics of the Medical Device Tax



The black lines in Figure 2 demonstrate the typical market equilibrium outcome familiar to anyone who has been exposed to basic economic logic. The red lines illustrate the impact from the tax. As Figure 2 illustrates, the expected impact from the tax will be less access to imaging technologies,

higher prices for patients, and lower returns for providers. The precise allocation of these costs will vary depending upon the specific price sensitivities of the patients and producers. It could be that patients bear all of the costs, producers bear all the costs, or some combination of the two. The only outcome that is not possible is that the tax does not distort the imaging technology market.

Policies that lead to some combination of higher medical costs and less availability of medical supplies worsens the problems facing the U.S. health care system. The tax's violation of generally accepted tax principles only increases the expected negative impacts from the medical device tax.

Starting with the neutrality principle, the tax is designed to tax only a subset of medical devices. Therefore, by conception, the tax imposes distortions into the medical device market, and creates incentives for manufacturers to seek loopholes and exemptions to benefit their products at the expense of competitors. Further, the tax will not impact manufacturers of the same device equally. Some manufacturers may be able to absorb the costs, or make up for lost revenues on one device by increasing prices on other devices. Other manufacturers may be unable to absorb these costs causing them to lose money. Consequently, the medical device tax violates the core principle of tax neutrality.

"Consequently, the medical device tax violates the core principle of tax neutrality."

Complying with the medical device tax is complex for many firms and the high compliance costs disproportionately harm smaller firms. For example, back in 2013 when the medical device tax was being implemented Pomerleau (2013) argued that

> one issue regarding complexity is how firms calculate the actual sales price of taxable medical devices. There are cases in which vertically integrated manufacturers sell directly to hospitals rather than through wholesalers. This requires them to create an artificial wholesale price upon which to apply the tax.
>
> Ultimately, the complexity of the tax places an additional, disproportionate administrative burden on smaller firms. Smaller firms, in the process of compliance, need to expend a greater percentage of their resources on administration than a bigger company. For many medical device firms, adding one more person in the tax department likely means not adding one more scientist in the R&D laboratory.[6]

The medical device tax is also hidden from the consumer who is generally unaware that this tax is priced into the costs of the product; has been applied inconsistently across products due to exemptions and short-term suspensions, which create difficulties for firms to plan and manage the tax; and, subjects some medical devices to double taxation.

The medical device tax's violation of generally accepted tax principles has also been noted by the Joint Economic Committee, which also argued that the medical device tax violates the tax principles of simplicity, transparency, neutrality, and stability.[7]

The Adverse Economic Consequences in Practice

Taxes that violate the principles of good taxation, like the medical device tax, impose unnecessary costs and inefficiencies on the economy in practice. As discussed above, these costs manifest themselves through some combination of higher consumer costs, lower business profits, lower employment growth or loss of jobs, and less innovation.

Perhaps most important, while studies may differ regarding the exact magnitude of the impacts, directionally all studies agree that the medical device tax will negatively impact the medical device industry specifically, and the economy more broadly.

For example, in a 2014 analysis by Congressional Research Service (CRS), the CRS claimed that the tax would have a small impact on the profits of device companies and would *only* reduce industry output and employment by no more than 0.2 percent "because of the small size of the tax and small share of health care spending attributable to medical devices."[8] Despite the small impact the CRS still concluded that "viewed from the perspective of traditional economic and tax theory, however, the tax is challenging to justify. In general, tax policy is more efficient when differential excise taxes are not imposed. It is generally more efficient to raise revenue from a broad tax base."[9]

"While studies may differ regarding the exact magnitude of the impacts, directionally all studies agree that the medical device tax will negatively impact the medical device industry specifically, and the economy more broadly."

Other studies have found larger impacts. For example, Daeyong (2018) examined how the tax impacted the medical device industry between 2013 and 2015.[10] He found that medical device companies' research and development expenditures fell $34 million, sales of medical devices decreased by $188 million, and the companies experienced lower overall profitability.[11]

A study by Bork (2017) found that the actual tax revenue raised from the tax was $2.1 billion below the estimated revenues over the 2013 and 2015 period.[12] These government revenue losses were a direct result of over $27.9 billion in lost industry sales, which Bork estimated would be expected to lead to job losses of 21,900 jobs between 2013 and 2015.[13] What is noteworthy is that the expected job losses are very similar to the actual decrease in employment in the medical device industry of 28,800 jobs during the 2013 to 2015 time period.[14]

Consistent with these findings, according to the U.S. Chamber of Commerce (citing an Ernst & Young report),

> venture capital funding for medical device companies fell 17% in 2013. The environment has become so difficult for medical device startups that Dr. Tom Fogarty, inventor of the balloon catheter, recently declared, "There is no way I could have had the same impact if the tax on medical devices was in place when I got started over 50 years ago." In addition, trade association AdvaMed, found the tax cost 33,000 jobs in its first year.[15]

It is important to emphasize the large impact from the medical device tax on smaller start-up companies because a great deal of innovation in the medical device industry is created by these businesses. Therefore, negatively impacting innovation at these smaller companies will have an outsized impact on overall industry innovation. As relayed by Frank Codella (CEO of Medical Acoustics) to the U.S. Chamber of Commerce,

> the medical device industry is largely driven by small companies with $10-$50 million in sales who depend on investment-fueled innovation. For these companies, there's "always a need for funding."

This makes the medical device tax "very misguided," Codella explained:

> It's a big industry driven by innovation. Innovation takes a lot of investment and R&D. When you put a tax on revenue and not on profits it goes right to the ability to innovate.[16]

The medical device tax is a larger burden on these start-up companies because smaller start-up companies will typically have thinner profit margins than larger, established, companies. Therefore, on top of all of the other costs a small start-up company faces, because of the medical device tax, a small company with $10 million in revenues now has additional costs of $230,000 (the 2.3 percent medical device tax multiplied by the $10 million in gross revenues). How the company will deal with these costs is unknown. Perhaps, some of these costs will be passed along to patients through higher costs for medical equipment. Of course, this would directly harm patient welfare and contribute to the overall affordability problem that plagues the U.S. health care system. Perhaps, some of these costs will not be passed on, which would then reduce the profitability of the start-up company. If the costs that cannot be passed along are high enough, then the 2.3 percent tax on revenues could turn a start-up company with minimal profits into a money loser, which consequently threatens future innovations. It is due to this impact on the profitability on the smaller, innovative, companies that the medical device tax threatens future innovation.

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It's Time to Repeal the Medical Device Tax

The medical device tax has an undeniably negative impact on the health care sector. The tax violates the commonly accepted principles of sound taxation and imposes economic costs that dwarf the revenues raised for the government.

> **"Eliminating the medical device tax will help encourage medical innovation and improve the quality of care provided by the U.S. health system."**

Further, while the negative impacts cited above have focused on the economic consequences, patient welfare is also impacted. Whether it is by forcing through cost increases that make medical technologies less affordable, or by stifling innovations and new technologies that could improve patients' quality of life, the medical device tax imposes adverse consequences on overall patient well-being.

As a consequence, the right policy response is to permanently repeal the medical device tax. As the Introduction noted, there is a current repeal bill that has been approved by the House of Representatives on July 24, 2018. While as of October 2018 it is unknown whether a repeal vote will take place in the Senate anytime soon, based on the economic merits, it should. Eliminating the medical device tax will help encourage medical innovation and improve the quality of care provided by the U.S. health system.

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Dr. Winegarden has 20 years of business, economic, and policy experience with an expertise in applying quantitative and macroeconomic analyses to create greater insights on corporate strategy, public policy, and strategic planning. He advises clients on the economic, business, and investment implications from changes in broader macroeconomic trends and government policies. Clients have included Fortune 500 companies, financial organizations, small businesses, state legislative leaders, political candidates and trade associations.

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