



A Principled

Approach to

Government

Research Report

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**Economics 101:
Why Pharmaceutical Price Controls Won't Work
Executive Summary**

"Limitations on the prices of commodities are not only ineffectual for the purposes proposed, but likewise productive of very evil consequences to the great detriment of the public service and grievous oppression of individuals."

-The First Continental Congress, June 1778

The benefits provided to consumers by the pharmaceutical industry over the past few decades are immeasurable. No one questions the role of antibiotics in eliminating diseases or the use of chemotherapy drugs in treating cancer. Many believe the prominence of drugs in the health care arena serves a preventative role; patients on prescription medication are less likely to seek repeated treatment by a doctor, and they are less likely to need expensive hospitalization and acute medical care. A recent study found that every dollar spent on prescription drugs is associated with a \$4 decline in hospital spending. Policy makers, concerned with skyrocketing health care costs, believe pharmaceuticals will save considerable money for government health care programs. They believe that contemporary medications could keep their patients healthy longer and, thereby, cut costs. One study concluded, "Open access to pharmaceuticals provides the best assurance of quality health care on the most cost-effective basis." The benefit of prescription drugs to the consumer is so high that some government officials now seem to believe that affordable access to these drugs should be considered a right.

Economics of Pharmaceuticals

- Complaints about the cost of prescription drugs particularly among senior citizens has become a politically sensitive issue. However, studies show 66 percent of seniors have a prescription drug plan, and several companies provide drugs free or at deep discounts to those who cannot afford them.
- The cost of developing a drug, from the initial design stages until its availability in drug stores, is around \$500 million. Drug companies spent \$24 billion in 1999 on the research and development (R&D) of new drugs, and 40 percent of that money went to drugs that never made it to market.
- Generic drugs, the inexpensive alternatives to brand name medications, are available at such low cost because their manufacturers do not participate in

R&D. Instead, they simply copy the original formula after the patent has expired.

- However, the patents don't expire until several years after a drug has reached the market, so generics are not viable options when the newest and best drugs are needed.

A Case for Price Controls?

- Some officials in America are beginning to call for price controls on prescription drugs, pointing to studies which seem to indicate that, in countries that have implemented such controls, prices for drugs are lower than in the US.
- However, results of studies vary, depending on the types of data collection and comparison methods employed. Some studies indicate that Americans actually may spend less per capita per year than residents of Germany or France, and only slightly more than those who live in Canada or Italy.
- In some countries, price controls have led to shortages and the lack of availability of new medicines. Many Canadians, come to the U.S. to buy drugs that would not otherwise be available to them.
- Low prices in Canada are also a result of significant tort reforms that limit jury awards in lawsuits.

The Problem with Price Controls

- Several states, including Texas, are studying price controls as a method of dealing with the high cost of pharmaceuticals.
- Economically, price controls increase the consumer demand for a drug, but they decrease the quantity supplied of that drug. This occurs because consumers want more of a drug when it is cheaper, but producers make less of a drug when they receive less money for selling it. The result is a shortage, the well-known consequence of any form of price controls.
- In 1994, when the Clinton health care proposal was being considered, pharmaceutical price controls were included in the plan. In response, drug companies drastically reduced spending on R&D, fearing that price controls would eliminate their profits.
- U.S. drug companies do 36 percent of the R&D in the world, and have developed 45 percent of all drugs created from 1975 to 1994.
- When Medicare implemented a price control on a drug for its patients in 1994, the demand increased so greatly that the government had to ration supplies to its Medicare patients so that only those whose condition was most critical could receive the drug.
- The Congressional Budget Office (CBO) evaluated a Medicaid price control effort in 1990, concluding that the mandated discounts a) encouraged providers to use other treatments besides the controlled one, and b) raised prices to other groups who had previously negotiated discounts. The CBO concluded that the effectiveness of price controls to control health care costs is limited.
- In addition to shortages, price controls on prescription drugs could cause, black markets to spring up and could also increase the potential for counterfeit

medications. This is seen now in Mexico, where it is estimated that one-fourth of drugs sold is counterfeit.

Solutions

- Solutions to high cost pharmaceuticals should not expand government nor inhibit the free market.
- Attention should be given to developing affordable prescription insurance policies for seniors.
- Efforts should be made to implement tort reforms that would eliminate exorbitant lawsuits against drug manufacturers, thereby significantly lowering the cost of prescription medications.
- Should private sector solutions fail to provide adequate relief, a prescription drug benefit plan could be provided through Medicare to assist those with the greatest need.

Conclusions

In developing public policy, lawmakers must always be aware of the of the law of unintended consequences which states that changes intended to correct one problem sometimes inadvertently cause problems in other areas. Clearly, implementing price controls on pharmaceuticals would be an example of this law in action; therefore, it would be the wrong way to respond to the need for increased access to affordable prescription drugs. Such an approach would ignore viable and potentially more economical private-sector solutions to the problem, and it could also permanently damage the pharmaceutical industry. The resulting shortages of prescription drugs, combined with the potential of lesser quality drugs coming to the market, could negatively impact the health of all Americans.

Price controls have always been a failure economically, politically, and socially. Countries that have implemented such policies are dealing with shortages of prescription drugs, long waits to receive the newest medications, poor quality drugs, and counterfeit drugs. Texas needs to avoid the pitfalls other states and countries have faced and implement policies that demonstrate what can be accomplished when the individual and the free market combine to create innovative products at competitive prices to improve the length and quality of life.