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Policy brief: Some Economic Concerns about Policies to Reduce Prescription Drug Prices

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SEPTEMBER 2019

Many proposals being considered in Congress and by the Administration would establish new rules and regulations regarding the pricing of prescription medicines. As these changes are considered, it is important to bear in mind that there are significant tradeoffs involved in most such proposals and that the actual effects may differ substantially from the intended effects. The economists' common refrain, "There is no such thing as a free lunch," applies. Many of the price control approaches under consideration will lead to unpredicted responses by economically motivated companies and market distortions that may end up making people worse off.

What are the likely tradeoffs? Of course, most economists would point to the expectation that rational actors (including big companies, small start-ups, and the investors that fund them) will respond to reduced return on their investment in R&D by scaling back such investment. In addition, companies with products already on the market will have the incentive to adjust to changing rules in a variety of ways that drive the unanticipated consequences one should care about if one is interested in the well-being of people who rely on medicines today and far into the future.

I. WILL PRICE REGULATION REALLY HAVE IMPACTS ON INNOVATION?

Given the headlines that successful companies and certain new drugs attract, it can be difficult to accept the idea that the economic returns to investment in drug discovery and development are not highly favorable. Nevertheless, various indicators suggest that profits earned in this sector are roughly in line with the risk-adjusted cost of capital the companies face, and that the economic return to investment in bringing new drugs to market has fallen in recent years to levels that cause concern about the sustainability of future drug development.[1] Believe it or not, investing in the development of new medicines is nothing like a sure path to riches.

To the extent that new regulations on prices further reduce the return to innovation, investors will be encouraged to turn their attention to other sectors of the economy that promise greater returns, and investment in the search for new medicines will decline. Unfortunately, it is very difficult, if not impossible, to say what the long-term cost of such a reduction in innovation would be. Certainly, evidence suggests that diminishing financial incentives on the industry will lead to fewer new drugs developed, but we will not know which new medicines will not be invented. We simply will not know what we are missing. We can suggest that people with serious rare conditions may never see a cure; efforts to find cures and effective treatments for cancer, dementia, and diabetes will diminish; and the next time a new deadly virus emerges, such as HIV, the industry will be less ready or able to respond.

1 Ernst R. Berndt, Deanna Nass, Michael Kleinrock, and Murray Aitken, "Decline in Economic Returns from New Drugs Raises Questions about Sustaining Innovations," *Health Affairs* 34, no. 2 (2015); Henry Grabowski and Richard Manning, "Drug Prices and Medical Innovation: A Response to Yu, Helms, and Bach," *Health Affairs* (blog), June 2, 2017, https://www.healthaffairs.org/do/10.1377/hblog20170602.060369/full/; Richard Manning and Saurav Karki, "Economic Profitability of the Biopharmaceutical Industry," Policy brief, 2018, https://www.bateswhite.com/media/publication/175_Economic%20profitability%20of%20the%20drug%20industry.pdf.

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It has always been the case that only a handful of medicines succeed in bringing in sufficient revenue to finance investment in R&D. Policies that target these most successful medicines will have disproportional impacts on innovation. For example, policies that impose new rebates for products paid for in Medicare's Part D catastrophic phase would reduce incentives for innovation in medicines most commonly used in that phase, such as cancer drugs or other specialty products that treat serious and sometimes rare diseases that have relatively high prices.[2]

However, not all impacts of such regulations would be immediately apparent. Even under the most draconian of price regulations, it is unlikely that companies would stop selling products that are already on the market or that they would shut down operations generally. For existing products, the high costs of product discovery and development have already been incurred. As long as companies could continue to set prices sufficiently to cover the incremental costs of manufacturing and marketing, they would continue to sell their products. Moreover, products that are in late stages of development may continue to be developed if the expected future revenues exceed the remaining costs to be incurred. Hence, it might appear for a time that drug supply and innovation are not affected. Those drugs that are near approval and that companies believe they will still be able to sell at prices that cover incremental costs will most likely continue to be launched. However, these impacts will depend on how extensive and deep new restrictions on pricing would be.

Arguably, the larger, and more serious effects of regulatory restrictions on market-based pricing would happen over the longer term as companies and investors in these enterprises adjust to a new reality in the returns to investments in medical innovation.

II. WHAT WILL BE THE MOST IMMEDIATE EFFECTS?

Most immediately, one can expect efforts by companies to minimize the adverse effects of any limitations on market-based pricing on their shareholders. For example, in response to new or increased rebates in Medicare or Medicaid, companies may be expected to make greater efforts to raise prices and shift costs to private sector plans paid for by employers and individuals. There is evidence that such strategic behavior was the result of manufacturer rebates when Medicaid rebates were introduced in the OBRA90 legislation.[3]

Moreover, there are situations in which the full value of a new medicine is not known at the time of launch, and as new, more valuable uses of a drug are discovered, market forces lead prices to rise to reflect that value. Limits on price increases over time give companies an incentive to launch new medicines at higher prices initially than they otherwise might in order to hedge against the risk of not being able to set prices based on value with the discovery of new valuable uses.

2 *See* Scott Gottlieb, Benedic N. Ippolito, and Abigail Keller, "Understanding the Impact of the Newly Proposed Senate Drug Pricing Legislation on Manufacturers' Investment Decisions," *AEIdeas* (blog), Sept. 9, 2019, http://www.aei.org/publication/estimating-the-impact-of-the-newly-proposed-senate-drug-pricing-legislation-on-manufacturers-investment-decisions/?mkt_tok=eyJpIjoiWW1ZM04yWXpNamd6WVROayIsInQiOiI2MjYrc1pjWU1wNHkzbWF4NUxNYll6TFA1VzdUcGhmNlNMWE9qdmNqREZDOUZIanNSR29NbDlzOXVqbk1rQ3EwWHRZVlVXd1dTem9TNW8xSEV1VDNwb2NHQ25GT3ZBdW1YMlNHb2p5RlI5dnMxMzR4eXNCc3A1OUM4SzBEWldnMyJ9.

3 *See* Fiona Scott Morton, "The Strategic Response by Pharmaceutical Firms to the Medicaid Most-Favored-Customer Rules," *RAND Journal of Economics* 28, no.2 (1997): 269–90; and Mark Duggan and Fiona M. Scott Morton, "The Distortionary Effects of Government Procurement: Evidence from Medicaid Prescription Drug Purchasing," *Quarterly Journal of Economics*, 121, no. 1 (2006): 1–30.

III. SO WHAT SHOULD BE DONE ABOUT PRICES?

People are obviously concerned about the cost of medicine, and the pressure for change is serious. As Congress and the Administration work to respond to this pressure, there are things that can be done that will address the most genuine of concerns, yet do little if any damage to the incentives to foster truly valuable innovation. Among these things are:

- Fostering competitive entry for "older" products that have lost exclusivity so prices will come down due to the competitive forces that work well in many parts of the prescription drug industry.
- Reducing the cost of regulatory review so that new innovative therapies can come to market at lower cost and appropriate returns to innovation can be earned at lower prices.
- Encouraging innovative financing mechanisms so that patients can directly see the benefits of the competitive forces that drive negotiated discounts for the prescription medicines they buy.
- Enhancing competitive forces by eliminating incentives in certain programs that cause payors to benefit from higher prices.

Of course, none of these is a panacea. People will always want lower prices for everything they buy, including medicines. People are eager for that free lunch that economists say they can't have, and they will keep hoping someone will provide it. If we can identify ways to address the most pressing concerns but at the same time maintain appropriate incentives for worthwhile investment, people can have more of what they need, even if they can't have exactly what they want.

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