

Competition lowers the cost of medicine

In many countries, new pharmaceutical products are subject to direct price controls. A recent study of six countries with varying degrees of price freedom for new medicines found that price freedom permits competition, which tends to lower pharmaceutical prices. The author asks why the full effect of this competition should not be encouraged.

The pharmaceutical sector is a key component in the economic and social welfare of all countries. Yet today, various constraints and pressures facing the industry worldwide are making the environment in which it operates markedly tougher. These range from regulatory inflexibility, unpredictability and outmoded controls, to a weakening of intellectual property rights. Such pressures are often combined with diverse and inconsistent government policies on drug price and reimbursement levels set by various national authorities. Because governments are under pressure to contain overall health care costs, they have often targeted pharmaceuticals. As a result, price regulation is not uncommon, even given the fact that drugs account for only a relatively small and often declining proportion of health care spending. In addition, some governments, particularly the US government, have also focused on the regulation of research and development activities, often imposing highly complex, time-consuming licensing procedures on innovation. Still others heavily regulate the industry's distribution mechanism, stifling institutional evolution.

Are these policies worth their cost? A recent empirical pricing study of six countries - Denmark, Germany, the Netherlands, South Africa, the United Kingdom, and the United States - examined whether there are any economic advantages in allowing entry to markets at the manufacturers' risk and at prices of their choosing. The evidence shows that considerable economic advantage for customers results from allowing free access to pharmaceutical markets, and that these advantages would be lost if regulators opted to limit access on grounds other than safety or efficacy. Furthermore, institutional evolution in the marketplace is reinforcing the competitive pressures of product innovation as novel distribution channels emerge, not only competing with each other, but imposing further constraints on factory exit prices.

The multi-country study found that, in markets where there is some semblance of pricing freedom, competition tends to keep down the price of medicines. And contrary to the claim made by some regulators, rival products serve a useful purpose in containing market prices. In fact, competition is seldom more evident than it is in the pharmaceutical industry, and innovative rivalry is the *sine qua non* of pharmaceutical markets. Unfortunately, the very existence of price controls (whether of the reference pricing variety or product-by-product controls as exist in some European countries) carries with it the implication that prices are not competitively determined. Historically, after World War II, price regulation in Europe was not confined to pharmaceuticals; controls were pervasive. Gradually, in the West, they were dismantled, until only pharmaceuticals remained under regulation. The increasing intensity, not just the continuation, of price controls on pharmaceuticals in Europe has come about as a reaction by governments to the ever-increasing costs of paying wholly or partially for health care in a welfare state. This was exacerbated by the fact that, once in place, price controls are difficult to remove.

The outcome is to distort the incentives for the supplying industry (and so discourage the innovation activity wanted by consumers). Given international trade, autonomous governments and exchange rate fluctuations, another result of price control is to introduce wasteful anomalies. This is not to argue that there should be no pressure for cost containment in pharmaceutical expenditures. The issue is how that pressure should be applied.

The pricing patterns revealed in the six countries studied suggest that competitive forces are far from repressed in pharmaceutical pricing. But the question must then be posed: Why not permit the price depressing influence of competition its full effect? Why distort or suppress competition by regulation at the level of the manufacturer or the retailer? Why not encourage it by enhancing information flows to prescribers and patients?

The alternative to regulation is competition to enable consumers to discuss information and product attributes and, in particular, price. Prices assist consumer choice, and choice exercised provides the ultimate benefit of therapy. Artificial suppression of price by regulators distorts choice. Attempts to discourage innovation by regulation reduces choice. And, by extension, distorted and reduced choice distorts and reduces - in the patients' and prescribers' eyes - the values to them of the ultimate benefit of therapy and cure.

South Africa: Summary of Innovative Pricing Levels

Year	A Sub-markets with innovations	B % of sub-markets where innovations were launched at a discount	C % of sub-markets where discount exceeded 25%
1989	23	87	48
1990	34	62	50
1991	38	66	58
1992	34	65	47
1993	44	59	48
1994	48	63	42
1995*	25	72	40

* First nine months only

South Africa: Sub-markets with innovations by price change category

Year	1995
% of sub-markets with...	
price falls of more than 10%	21
price falls of between 5% and 10%	8
price falls of 0% to 5%	38
price increases of 0% to 5%	21
price increases of between 5% and 10%	4
price increases of more than 10%	8

Note: A sub-market is a market within which products are in close competition – for example, analgesics, anti-depressants and cardio-vascular products are in distinct sub-markets. Thus diabetic preparations do not compete with tranquillisers, they compete with other diabetic preparations, tranquillisers compete with other tranquillisers, and so on. Over 80 of these sub-markets were examined in the study.

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His full study, Medicine Prices and Innovation: An International Survey, can be obtained from the Free Market Foundation.*