IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.

July 22, 2003 **Advisory No. 158**

SNATCHING DISEASE FROM THE JAWS OF VICTORY? REIMPORTATION OF DRUGS IS A DANGER TO RESEARCH AND FUTURE GENERATIONS

The House of Representatives is about to vote on a proposal, introduced by Representative Gil Gutknecht (R-MN), to allow U.S. residents to freely order U.S.-made prescription drugs from Canada and Europe, where they are often available at less than half the price charged in the United States. This "reimportation" of U.S. drugs would certainly save current drug users money, but at a high cost. Reduced revenue from drug sales will erode the ability and the incentive for drug companies to undertake the very risky and expensive process of developing new medicines. The reimportation bill will deny new and improved treatments to tens of millions of future patients, resulting in earlier death and reduced quality of life compared to what these people could have under current law.

Reduced revenue from drug sales will erode the ability and the incentive for drug companies to undertake the very risky and expensive process of developing new medicines.

Heavy-handed lobbying techniques and the unsympathetic view that many Americans have of drug companies may lead some Members of the House to cast their vote for the bill. This would be a shame, because on the merits, the bill is horrible economic, social, and health care policy.

In recent years and months, new developments in biology and chemistry have opened up amazing opportunities for progress against heart disease, cancer, and viral diseases of all sorts, including AIDS. The human genome has been deciphered. Genes responsible for a wide range of diseases are being pinpointed and analyzed to determine what countermeasures might be possible. Scientists are learning how to tailor a drug to the specific genetic makeup of a cancer patient's tumor. Our understanding of the chemistry of cells and viruses is growing apace. One would think that society would be urging the research community to take the fullest advantage of these scientific advances by translating them as fast as possible into practical pills and treatments.

Instead, the public and the politicians are focused on the cost and affordability of existing medicines and treatments. Their knee jerk reaction is to impose price controls, or let people import drugs from abroad where other governments have set low prices, or to demand discounts for patients in their states or in specific federal programs. The direct result of ratcheting down the returns on drug development will be to slow the rate of scientific advance and delay the introduction of new medications and treatments made possible by the new science. This is a real and inescapable result, and it is true even if the drug companies are among those who say so.

The ability of poor Americans to afford medication is a legitimate concern. But drug affordability is a welfare issue, arising because some people have low incomes. It is not a problem with the price of the drugs. The right reaction is to leave

the drug prices alone and to give the poor the wherewithal they need to buy their medication, just as we help them to buy food and housing with welfare checks, housing vouchers, or food stamps.

In a normal market, the prices of goods and services cover the costs of producing them. Consumers pay for what they get, and get what they pay for. If we are not willing to make patients pay for the cost of their medicine, including the necessary R&D and testing that make possible the pills they consume, then some other way of letting the drug innovators recover their costs will have to be found, or the research will stop. The government would have to step in to subsidize drug research, perhaps with a double deduction for R&D expenses, to reduce the development costs. Then the taxpayer would pay for part of the cost of the drugs, and the consumers would pay the rest. But someone must pay for those research scientists, their lab equipment, and the chemicals they use, one way or another.

[D]rug affordability is a welfare issue, arising because some people have low incomes. It is not a problem with the price of the drugs.

It is not just the drug companies that claim that reduced revenues will interfere with new drug development. Economists would have to agree that they are speaking the truth. In fact, the situation is a crystal clear textbook case of the economics of the firm, right out of price theory 101.

Normal industries face modest research and other fixed costs, and face rising marginal costs as production is increased and resources become stretched. In such cases, the competitive market price (equal to marginal cost) is enough to cover fixed costs as well as the costs of each additional unit. Other industries, however, have a very different cost structure, with high fixed costs and low and flat marginal costs. The normal market outcome does not work well for them or for the consumer.

The drug industry is a good example of an industry with high fixed costs and low marginal costs. It may take a billion dollars of research to test thousands of potential chemicals for use against a disorder, find a few good candidates for development, test them for efficacy and safety, settle on the best, and develop a reliable and efficient manufacturing process for turning it into a marketable medication. Once perfected, however, it may cost very little to produce each additional pill or dose. Marginal cost pricing will be less than average cost, and will not be enough to recover the research costs and keep the company in business. In such cases, the product will be developed only if the discoverer can obtain a patent or license giving it the exclusive rights of production for a time. The firm can then charge a monopoly price above the marginal cost, and at least equal to average total cost, to recover its development costs. If, instead, other companies can readily and immediately copy, produce, and sell the product at the low marginal cost, then the costs of the original research are much harder to recover. Research is discouraged, and will not be undertaken at the socially optimal rate.

It was precisely to deal with such cases — to foster discoveries and innovations and the creation of new products — that patent protection was instituted by civilized governments around the world. It is why the U.S. patent office was one of the first federal agencies established after the ratification of the Constitution and the creation of the federal government. A patent grants a temporary monopoly that allows the innovator to charge more than the marginal cost of the product, giving it a chance to recover its development and other fixed costs and to earn a return on the investment. Then, when the patent expires, the good is open to competition and the price is driven down to the competitive level. Innovation is fostered, but consumers are protected longer term by the expiration of the patent.

As with anything else involving intervention in the market, the patent process involves striking a balance. Longer patents would increase the incentive to innovate (which helps future consumers

by creating new and better products), but would increase the cost to current consumers. Shorter patents or patents rendered ineffective by reimportation would hurt innovation (and the consumers who would benefit from it), but help current consumers in the short run.

Patents, therefore, have a clear economic purpose. If politicians and the public think that patents are merely the result of some bizarre form of political clout and can be dispensed with without serious economic consequences, then those people are wrong.

If it is critical for drug companies to charge more than the marginal cost for a time, why do they sell drugs so cheaply abroad? The drug companies sell abroad at the reduced prices set by foreign governments with socialized medicine because those governments set the prices just above marginal cost, and a little net revenue is better than none. Similarly, they sell to poor countries where demand is very weak at prices just above marginal cost. Anything above marginal cost adds a bit to net revenue, but the skimpy foreign profit margins are not enough to contribute meaningfully to covering the fixed costs of research, development, or the production lines.

Indeed, consumers in developed countries with socialized medicine are shirking their responsibility to help fund medical research. Consumers in poor countries can barely afford the marginal cost of a pill, and cannot contribute much, if anything, to the development costs of the drugs either. Drug companies can recover the costs of new medicines only in the United States, and only by charging more than the marginal cost of the additional pills. Only in the United States are the prices sufficiently above marginal cost to cover those fixed expenses. Only in the United States do the companies earn enough to pay for the fundamental science, the dead ends, the testing of compounds that do not pan out, and the tests for safety and efficacy demanded by the FDA. As irritating as that is for American consumers, the alternative is worse: not to have the drugs at all.

Drug companies can recover the costs of new medicines only in the United States ... As irritating as that is for American consumers, the alternative is worse: not to have the drugs at all.

The United States paid more than its share to defend the free world against the Communist threat, and is paying more than its share to fight terrorism. It should come as no surprise that we are being asked to pay more than our share in the fight against disease. But the alternative is to surrender millions of American lives to historic biological enemies that we are now able to vanquish. It would be snatching disease from the jaws of victory.

Stephen J. Entin
President and Executive Director