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Government Demand for Drugs and Drug Prices-Becker

In determining whether governments should use their monopsony power-defined well by Posner- to reduce drug prices, it is essential to distinguish between generics and drugs that are still protected by patents. Generics are produced under competitive conditions because they typically become available only after patents on drugs expire. The production of generics would be inefficiently low if the government used its buying power to force down prices to the government, and to patients, to levels where demand for drugs by patients exceeded the supply of these generics.

Even a government monopsonist can avoid causing such an inefficiently low output of generics if it bought generics at competitive prices, but required generic drug producers to give them upfront payments in order to get their business. This is called two-part pricing in the literature on monopoly pricing, and applies fully not only to government monopsonists, but also to unions that set wages along with employment of their members. However, successful two-part pricing is delicate to achieve, and if used unwisely on generic producers it could force some of them out of business in the long run because they cannot obtain a decent return on their capital investment.

The wisdom of the government's using its economic power to lower the prices of drugs it buys is even more questionable for drugs under patent protection. The whole purpose of patent laws is to give drug innovators monopoly power for a period of time in pricing their drugs in order to encourage the R&D research that leads to these innovations. The government would be taking away with one hand what it gave with another hand if it then used its buying power to take back some of this pricing power.

A different version of two-part pricing might help even with patented drugs. The government could arrange to pay producers of patented drugs a certain amount upfront if they sold units of the drugs to them at the cost of producing these drugs. Such upfront payments would help offset the large spending on R&D required to discover successful drugs. The major difficulty in this approach is in determining the size of these upfront payments to drug companies, especially when the media and members of Congress would be quick to claim a sell out to powerful drug lobbies.

One reason why companies and researchers in the United States are greatly overrepresented in the development of new diagnostic and therapeutic drugs compared to say Europe (see, for example, the paper by Whitman and Raad " Bending the Productivity Curve: Why America Leads the World in Medical Innovation", November 2009, Cato Institute) is that prescription drug prices are about 50% higher in the United States than in Europe. Another factor is that almost half of all pharmaceutical sales are in the US.

Posner recognizes that especially persons under government Medicare and Medicaid are encouraged to buy an excessive amount of drugs relative to their medical needs because their co-payment rates are only a fraction of the total cost to the government. Posner also believes that advertising and other promotion of drugs induce consumers to buy more drugs than they really "need". Perhaps that is true, although I am doubtful. Stil, both these considerations suggest that the government should force consumers to pay more for drugs under Medicaid and Medicare. Higher consumer prices could induce consumers to eliminate any "excessive" use of drugs. Whether the government could politically get lower prices from pharmaceuticals and yet force many consumers to pay more is surely questionable.

A different reason why investments in developing new drugs may be excessive is that it is hard to deny the use of new drugs once they are developed, even when new drugs are only slight improvements over existing drugs. The difficulty in denying their use may arise from political pressure by the elderly and others who benefit, even if only by a little, from

the new drugs. In addition, children who help their elderly parents pay for their medical care may feel “guilty” in not allowing them to consume the latest drugs, even when they add little to their parents health and longevity.

Other considerations, on the other hand, suggest that drug companies may not spend enough on developing new drugs. One is that even elderly people appear to be willing to pay a lot of their own resources for small extensions in their life-see the various Rand experiments on demand for medical care. Persons with serious diseases believe or hope that if they can extend their lives even for a short while, new drugs will come along that will greatly improve their life prospects. This happened during the 1990s for persons with Aids since Aids cocktails developed then that greatly extended lives of persons with Aids. Very sick patients with these expectations would be willing to spend a lot for relatively small initial extensions in their life expectancy.

Another reason why too little may be spent on developing new drugs is that companies with blockbuster patented drugs collect only a fraction of the total benefits to patients, despite the high prices they charge. This is partly because similar drugs are often developed prior to the expiration of the patents of the original drugs.

The net outcome of all these forces is that the American government would be unwise to use its economic power to force down drug prices, unless it used sophisticated forms of two-part pricing of drugs. I believe that in the long run major drug discoveries lower rather than raise medical spending by reducing the need to rely on lengthy hospital stays and expensive surgeries to treat serious diseases.

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Mr. Becker,

Can we use the economic models of other countries which currently exercise this practice as an example? Generic vs. Patent-protected drugs could be looked at individually in this case, I would imagine. It would seem that this would point to the long term success or failure of such a policy.

However, if only "some" countries are exercising their respective monopsony power to drive down the cost for drugs to their nations, as with textbooks, are Americans not actually overpaying above what would otherwise be an economically efficient price?

Lastly, re: advertising, would not the existence of such a prolific amount of drug advertising suggest that demand is highly sensitive to it? I would surmise that this would, at least somewhat, substantiate Mr. Posner's claim that advertising causes consumers to buy drugs that they don't "need." If it doesn't, I would think it would then suggest that Dr's overall have been remiss in adequately caring for their patients (unless we assume that only doctors are receptive to such advertisements; we cannot).

Thank you both for the excellent and thought-provoking analysis.

Posted by: Brian Stone | 12/28/2009 at 08:52 AM

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