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Testimony: Prepared Statement for HHS Task Force on Drug Importation

Jeff Lemieux
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Summary: Drug importation should be addressed as a complex international trade and public health issue. Free import and export of drug prices may seem like a good deal for rich countries with high prices. U.S. citizens could get the same low prices enjoyed by less developed countries or compelled by other rich countries with tight price setting systems. But it could be a bad deal for poor countries, which might no longer be offered low prices for medicines.

Outline:

Thank you, Dr. Carmona and members of the task force, for inviting me. My name is Jeff Lemieux, and I'm the executive director of Centrists.Org. Our mission is to help policymakers develop ideas that could achieve lasting bipartisan support on some of the toughest national issues -- health care, budget deficits, social security, and so on.

To many members of Congress and a wide swath of the public, importing cheaper drugs from Canada is a no-brainer. Leaving the safety issues aside for a moment, most people think it's just perfectly logical that if we can get a better deal on medicines from other countries, we should.

So it's only natural that economists will bring up the "on the other hand" concerns.

In general, I believe drug importation should be addressed as a complex international trade and public health issue. Free import and export of drug prices may seem like a good deal for rich countries with high prices. U.S. citizens could get the same low prices enjoyed by less developed countries or compelled by other rich countries with tight price setting systems. But it could be a bad deal for poor countries, which might no longer be offered low prices for medicines.

I know the task force has heard from consumer advocates and elected officials about the importance of reducing prices and improving drug coverage for the uninsured and people with low incomes, especially senior citizens. That's an extremely important topic, and I applaud the advocates working on the issue. But since it has been discussed already, I won't talk about that.

I know that the task force has also heard from experts on security and people with devastating diseases who are very concerned about the safety of drugs imported from other countries. And I'm sure the task force will discuss the proper public policy balance between lower prices and future investment in research and development of medicines. Again, these are very important topics, but my statement only contains a mention or two.

Instead, I'd like to offer a very simple economic analysis of globalization and how medicines would be priced around the world if unrestricted trade in pharmaceutical prices became the norm.

Free Trade in Drug Prices

There are three characteristics that differentiate trade in medicines from trade in other products or services.

First, the industry is extensively involved with government. Governments sponsor basic research, monitor safety, and, in many countries, purchase drugs directly or set prices.

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Second, with medicines, there are strong moral issues and economic "externalities" -- that is, if some people don't take their medicine or get vaccinated, other people will get sick. If people can't afford Toyotas, governments don't necessarily regard that fact as a public policy issue. However, if people don't get the proper medicines, that is a public health problem as well as a moral and economic issue.

Third, the main cost of medicines is discovery and development, not production. This is similar to the software industry and, in some respects, the telecommunications sector.

Production costs are very low for many drugs. Even for bio-tech medicines with extremely delicate production and storage requirements, the development costs are far higher. This "high fixed cost, low variable cost" structure is why successful drug companies can make huge profits, and why companies whose products fail disappear quickly.

Modern global trade usually involves a search for lower production costs. If computer programmers in India can do the same job cheaper, companies all over the world will hire them. If toys can be produced at a lower cost in China, the world will import Chinese toys.

However, my impression is that production costs for drugs are fairly similar throughout the world. There may be tax breaks for production in Puerto Rico, or good deals on facilities in Ireland, but overall, production costs are a very small part of the cost of medicines -- they are not what international trade in drugs is all about.

Instead, trade in drugs is essentially a search for the lowest pricing system.

Prices, in turn, are determined by government policies, moral and public health concerns, and the desire by drug companies to price their products in each country or market to achieve the maximum possible "contribution" toward their fixed or "sunk" development costs. (In its simplest definition, contribution is the difference between revenues from drug sales and production and marketing costs -- in a sense, it is the amount that "pays back" development costs and thereafter adds to profits.)

One World Price

I believe that the long-run impact of widespread international trade in pharmaceutical prices would be a new equilibrium with overall global prices not too different from today's.

However, the distribution of global prices would change. U.S. retail prices for people without insurance or group discounts would fall. Over time, other developed countries with price controls would probably see some upward pressure on their prices.

But the big question is: What would happen in the less developed countries?

For most products, free trade leads to a long-run tendency toward one world price. Usually, when products are tradable between countries, and when they are produced and sold in competitive markets without government price controls or quotas, exchange rates and markets gradually adjust toward "purchasing power parity," that is, a dollar buys roughly the same thing in different countries.

Economic theory sometimes works slowly or in messy ways. Some countries may have import duties, and others may be a long way from a factory. Sometimes price differentials between countries can persist for years, either because of special market factors, government policies, or exchange rates that don't adjust quickly. Some companies may offer discounts in particular countries to try to expand their distribution or build brand loyalty.

But in the long run, the same Toyota should cost roughly the same amount, wherever it is purchased.

To someone in Ghana or the Dominican Republic, however, a Toyota might cost more than he or she earns in a decade, or a lifetime.

Policymakers should debate whether we really want one world price for medicines.

In a world with unrestricted trade in drug prices, drug companies will respond in their financial interest. They will try to limit the supply delivered to countries that export their low drug prices.

These supply responses by producers will gradually lead importers to search for lower prices in poorer and poorer countries. For example, importers bringing Canadian-priced drugs to the U.S. will look elsewhere when Canadian export supply runs low. Because prices for medicines currently vary widely from rich to poor countries, the drug-price arbitrage business will be just too lucrative to avoid that temptation.

When Canadian trade tops out, importers will turn to other rich countries with low government-set prices. When those sources run low, in turn, importers will begin to seek supplies from lower-priced developed countries like Portugal or Greece, or Taiwan or Korea. Ultimately, poor countries will be targets.

As price-arbitrage spreads, the natural tendency is for prices to settle at one global rate.

Of course, there are people in the U.S. who can't afford medicines (or Toyotas). I believe we should help those people with bigger tax breaks to increase their take-home pay, education subsidies, and health insurance, as a matter of public policy.

Certainly, lower income-seniors in the U.S. need help purchasing expensive medicines.

But do we really want Egypt or Thailand or Peru or Turkey to pay the same price for medicine as the U.S. or Canada or Sweden? Importation might reduce drug prices in the U.S. a little, but it could increase prices in the Philippines or Mexico or Pakistan by quite a lot.

Moreover, I'm not a safety expert, but imports from poorer countries would clearly pose greater risks of adulterated, improperly handled, or counterfeit products.

The bills in Congress to legalize drug importation say we're not going to allow importation from less developed countries. But over time, without a great deal of international cooperation, there would be great pressure to do so, and we can expect a lot of leakage.

International Cooperation

Let me close with two recommendations and an extraneous thought.

1. The FDA should probably invest heavily into tracking the production and transportation of imported drugs, regardless of whether or not legislation passes to make importation more widespread. The FDA shouldn't get hung up on legalities -- if people are importing drugs regardless of the law, then the FDA should still do everything it can to make sure they are as safe as possible.

2. The proper forum for a discussion of global drug pricing and trade might be the World Trade Organization or other international bodies. Perhaps less developed countries could help the developed nations monitor and control counterfeiting in exchange for lower-than-equilibrium prices. To some extent, markets will always tend toward one global price, and no trade regime will be airtight in stopping that. However, there may be win-win outcomes available through international cooperation, where drug companies are confident they can essentially give away medicines in the poorest countries and sell drugs for relatively low prices in modest-income developing countries without undue fear that this will undercut their prices in affluent countries.

Finally, price importation seems like an odd way to address drug prices. Government price setting has pros and cons. But the importation debate seems to sidestep what should be a very important public discussion.

Lower prices could lead to more effective use of drugs, especially by people with low incomes.

However, if investors believe their global returns on successful research and development will be lower, investment will also be lower -- there's no question of the economics of that decision.

Moreover, poorly set prices may lead to a shift in the types of investment undertaken. For example, suppose investors believed that "super-expensive but life-saving" medicines, which were targeted to diseases affecting only a small number of patients, would face strict price controls. Assume they also predicted that prices of "lifestyle" drugs -- designed to relieve symptoms of less serious ailments suffered by a vastly larger population -- would not be lowered within a price setting system. In that hypothetical case, investors would insist that companies shift research toward lifestyle medications, even though that wasn't the intended public policy.

This is the key balancing act for public policy: Should the U.S. mimic other countries and set prices for drugs, and, as a result, risk reducing or distorting investments in the sector?

Most economists believe that government price setting can cause economic distortions. The long-term impact of price controls can be unexpected and problematic. Therefore, price controls should be used only when there is a very compelling public policy reason.

However, health care is a special case, distinct from other parts of the economy. Many parts of the U.S. health industry already operate under government price controls.

Either way, economists will always say "there is no free lunch," and that the benefits of government price setting should be weighed carefully against the costs.

However, if Americans choose to reduce drug prices via price setting, it might make more sense to decide on the prices within our own government, rather than importing the decisions of foreign governments, which might not be in our national interest.

I'm not saying we should switch to government price setting for drugs in the U.S. I've been involved with some price control systems in Medicare that didn't work very well.

But if we want price controls for drugs, doing it ourselves could help ameliorate the safety worries associated with drug importation.

Our ultimate goal should be to balance the public policy debate, so that we understand the tradeoffs between prices and investment, and between trade flows and drug availability throughout the world. In the end, I believe the U.S. could benefit in many ways from the sort of international cooperation that will probably be necessary to prevent the forces of globalization from raising the prices of medicine in less developed countries.

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