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ECONOMIC VIEWPOINT

By Robert J. Barro



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Drugs Via Canada? The Side Effects Could Hurt

Those high prices for winners provide the incentive for R&D

A major challenge for health-care policy is the high price of prescription drugs. In his speech at the Democratic Convention, Senator John Kerry endorsed proposals to cut prices by facilitating reimportation of cheaper drugs from Canada. The rationale is to spur competition. Companies would be forced to compete with themselves. For example, Pfizer Inc.'s ([PFE](#)) direct sales of Viagra to the U.S. market would compete with its indirect sales, which go to Canada and would then return to the U.S.

The key feature of the pharmaceutical business is the up-front outlay for drug discovery. Drugmakers spend billions to develop new treatments and prove their efficacy and safety to the Food & Drug Administration. Much of this research-and-development expenditure goes into drugs that fail. However, once a company succeeds, the costs of production and distribution are small. Making and selling a million Viagra tablets costs little compared with the earlier R&D spending.

In order for the pharmaceutical market to function efficiently, companies must have incentives to invent new drugs. One possibility: The government could pay large prizes for successful drugs. Unfortunately, figuring out how much to award and for what is technically difficult and politically unlikely. Therefore, the incentive has to come from profits for selling successful drugs at high prices -- higher than the costs of producing already invented drugs.

THE INCENTIVE TO INVENT NEW DRUGS depends on worldwide profits. Some profits come from the U.S. market and some from abroad. U.S. consumers may not like paying the high prices that generate such profits. But everyone in the U.S. should be happy about foreigners paying high prices. Profits generated overseas raise the incentive to invent new drugs without requiring even higher U.S. drug prices.

So how does Canada fit in? If customers could be separated into distinct markets, drug companies would price at different levels in different places. For example, companies would charge relatively low prices in poor countries because sales at U.S. prices would be close to zero. For well-off Canada, profit-maximizing prices theoretically should be similar to those in the U.S. However, Canada's regulatory agency and the provincial health insurers have managed to hold down drug prices because they set price ceilings, buy in bulk, and negotiate directly with drug companies.

Canadians gain advantage from their regulations because they get existing drugs at lower prices and still benefit from new U.S. drug development. Potential profits from Canadian sales of drugs are a small part of worldwide U.S. drug company earnings, so the adverse effects on incentives are minor. Canada, however, is effectively free-riding (or rather, half-riding) on the U.S. by not paying its "fair share" of the profit incentives for drug discoveries.

What works for Canada would work for a single U.S. state, ideally a small one, such as Vermont, which already encourages reimportation from Canada. But this policy is a burden on the other 49 states. Think what would happen if residents of all 50 states got drugs at Canadian prices. Profits would fall, hampering the development of new drugs.

If Americans really want lower prices, there are ways to accomplish this without incurring the costs of moving drugs to and from Canada. The U.S. could shorten the period of patent protection from 17 years to 10, make it easier for generics to challenge existing patents (as Congress did to some extent in the 1980s), or regulate prices of patented drugs. Pursuing these policies would be a mistake because the current setup strikes a reasonable balance between incentives for invention and the prices of existing drugs. But at least these proposals would be intellectually more respectable than reimporting drugs.

Another point is that drug companies sell at 50% off in Canada only because they can reasonably well isolate the Canadian market from the U.S. one. Policies that facilitate reimportation of drugs make it harder to separate those markets. If the leakage to the U.S. became large, as it would if reimportation were fully legal and convenient, drug companies would be unwilling to sell in Canada at 50% off. The companies would insist on 100% prices or else would not sell there. Thus, Canada has the greatest self-interest in preventing massive reimportation of drugs to the U.S.

By Robert J. Barro is a professor of economics at Harvard University and a senior fellow of the Hoover Institution (rjbweek@harvard.edu)