

THE HIGH COST OF LOW COST DRUGS: WHY THE “CANADIAN MODEL” IS NO PANACEA FOR PRICING

by

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For several years Canadians have followed the spirited American debates in Congress and on the election trail regarding Canada's big prescription drug price advantage over the U.S. We've heard tale after tale about busloads of American seniors who make the long arduous journey north to that land of ice and snow just to fill their prescriptions. Politicians of course see opportunity in this crisis and hardly a week passes by without one of them condemning the big profits of U.S. pharmaceutical firms while proposing some new scheme to bring prescription drug prices into line with those in Canada. But in their haste to make political hay these legislators miss the fact that Canada pays a high cost to have low cost drugs. Regulating the price of prescription drugs along the lines of the Canadian model is not all it's cracked up to be; there is far more to Canadian prescription drug prices than meets the eye.

John R. Graham, Director of the Pharmaceutical Research Centre at the Fraser Institute, a free market think tank in Canada, noted in an article in the February 28th WALL STREET JOURNAL that, "Canadians are less wealthy than Americans today and drug companies have responded to this market segmentation by pricing lower in the poor country." He explains how this is possible:

(Glaxo) can sell at lower prices in Canada because manufacturing and distribution costs of a patented drug are a small fraction of its price. Most of the cost is sunk in research and development. If Glaxo's prevailing American price for a pill is \$1, and it costs a dime to manufacture, there's no reason for Glaxo not to sell it for a quarter to those who cannot pay a dollar for it.

One possible solution to lowering U.S. drug costs is for America to follow Canada downward into a lower standard of living. This is hardly a real option.

One oft-touted solution for the U.S. is to regulate drug prices as Canada regulates patented drugs. But this is simply one more attempt to get that ever-elusive free lunch. Regulated drug prices mean smaller profit margins for drug companies. This in turn means smaller returns for millions of investors including

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union pension plans and low-income seniors. Governments would then see the shrinking revenues of corporate and capital gains taxes. In some cases workers would have to be laid off, planned expansions would be canceled and wages would suffer. The effect on research and development would be dramatic. Lower revenues would mean smaller research-and-development programs and fewer life enhancing and life saving discoveries. Overall, for the economy it would mean a loss of productivity and therefore a lower standard of living. All of this assumes that companies didn't just pick up and move to a more business-friendly jurisdiction, causing even greater losses.

As of today Canada has lower patented drug prices than the U.S., but the cost is enormous. Canada pays for lower drug prices with our lower standard of living. We pay for regulated patent drug prices with a smaller than necessary R & D-based drug industry, which in turn leads to a lower standard of living. The U.S. would be well advised to count the costs before it heads down this path.

For instance, what would happen if the U.S., the world's primary consumer of prescription drugs, decided to regulate drug prices at below-market rates? In discussing government price fixing, economist Henry Hazlitt noted in his indispensable *Economics in One Lesson*, "the consequence of fixing a maximum price for a particular commodity would be to bring about a shortage of that commodity." Henry Hazlitt, *Economics in One Lesson* (San Francisco: CA, Laissez Faire Books, 1996) at 103. Given that the commodity in question here is life saving or life enhancing drugs, this is hardly desirable. It seems obvious that capital currently invested in the pharmaceutical industry would flee to industries without price caps where the potential to make bigger profits is greater. This is a problem that Canada can largely escape.

Canada can get by with price caps on American patented drugs because the large R & D costs associated with those drugs can be first recaptured in the wealthier U.S. market before these drugs can be sold more cheaply to their poor cousins in Canada. But if you also have a price cap in the U.S., there is no reciprocal ability to turn around and recapture those R & D costs in Canada, or anywhere else for that matter. Canada can free ride on U.S. research and development but it can't work the other way around.

Still, no matter how many times it has failed, price regulation is an idea that just won't go away. Whenever people start to complain about rising prices for "necessities" there will surely be a politician standing by to condemn the industry and to propose some kind of price control. But to be consistent, then shouldn't the proponents of price controls on drugs also propose that the prices of all necessities be regulated in order to ensure the well-being of those at the bottom end of the income scale? A list of necessities should probably include food, shelter, clothing, medicine and basic transportation. Just what would happen if we reduced the price of food to below-market rates out of concern for the ability of the poor to afford the very stuff of life?

But wait a minute. If we lower the price of food and squeeze the profit out won't consumers buy more while producers grow less causing shelves to empty out? Wouldn't capital flee to more profitable industries? On a larger scale wouldn't price controls only emulate the tried and failed communist model of the old Soviet Union? Applying price controls to U.S. prescription drugs would be to make the same mistake government planners have made since the origins of government. The effect would be devastating.

It is ironic that drug companies are in many respects the victims of their own success. Through their discovery of thousands of new medications that have led to the saving of millions of lives, expectations have been raised to the point that many people, especially politicians, now believe that access to these drugs at whatever price suits them is their *right*. On one hand politicians cheer on the massive capital investments these companies make in their state or district, but on the other hand, they seek to limit the ability of drug companies to fund these investments. We should be concerned that this logical disconnect, writ large, will lead to the destruction of the goose that has laid so many golden eggs for the benefit of all humanity.