Just Undo It

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Eakinomics: Just Undo It

There is an old saying that there are many economic puzzles but only two deep mysteries: What causes business cycles, and why do some countries develop while others stagnate? Much of the public discussion surrounding drug prices would seem to suggest that they are a candidate for a third mystery. But there really is no mystery. Rising drug prices are just bad policy in action.

For example, the Office of the Inspector General (OIG) of the Department of Health and Human Services (HHS) reported:

- "Total reimbursement for all brand-name drugs in Part D increased 77 percent from 2011 to 2015, despite a 17-percent decrease in the number of prescriptions for these drugs.
- After accounting for manufacturer rebates, reimbursement for brand-name drugs in Part D still increased 62 percent from 2011 to 2015.
- Part D unit costs for brand-name drugs rose nearly 6 times faster than inflation from 2011 to 2015. The percentage of beneficiaries responsible for out-of-pocket costs of at least $2,000 per year for brand-name drugs nearly doubled across the 5-year span."

As nicely exposited by AAF's Tara O'Neill Hayes, over this same period a variety of policies embedded in the Affordable Care Act (ACA) were simultaneously implemented: (1) an expansion in the Medicaid population, (2) an expansion of the 340(b) program, (3) an increase in the basic rebate (a payment from manufacturers to Medicaid) on brand name drugs, (4) a requirement that manufacturers "close the coverage gap" and pay one-half the cost of some Medicare outpatient drugs, and (5) a new tax on revenue from brand name drugs.

Medicaid "best price" is the original sin of drug-pricing policy. It requires that Medicaid receive the best price that manufacturers otherwise offer to other purchasers (or pay a fixed rebate, whichever is cheaper for Medicaid). This mandated discount undercuts the incentive to cut a good deal with, for example, a private insurance company, because that deal is automatically extended to all of Medicaid. The Medicaid expansion means that this policy became more prevalent in 30 states with 14.5 million new enrollees. The ACA also also extended this requirement to Medicaid managed care organizations.

The 340(b) program requires manufacturers to provide cheap drugs to — in principle — low-income patients. It was needed because Medicaid best price destroyed the incentive for charitable donations of drugs to help these individuals (which would have made the best "price" equal to zero). The policy and its bad consequences are nicely explained in detail here. As a result of the program's enormous expansion, the value of discounted drug sales rose from $6.4 billion to $12 billion, and climbed another 35 percent to $16.2 billion in 2016. Given CBO's estimate that the average 340(b) discount is 49 percent, manufacturers provided an estimated $39.7 billion in 340(b) rebates from 2011-2015.

The ACA also increased the rebate amount for brand-name drugs by 53 percent, up to 23.1 percent. When

combined with these expansions, this increase meant that drug manufacturers had to provide their drugs at roughly three-quarters of the normal price to nearly a quarter of the U.S. population. The cost of the higher rebate and larger population meant that from 2011 to 2015 drug manufacturers provided rebates to the Medicaid program of approximately $80 billion.

Next, drug manufacturers had to pay rebates of 50 percent of all brand-name drugs provided to Medicare Part D beneficiaries in the coverage gap phase of their benefit. Between 2011 and 2015, these mandatory rebates cost drug manufacturers $19 billion, and another $5.6 billion in 2016.

Finally, the new tax on brand-name drug revenue cost the industry $14.1 billion between 2011 and 2015 and has cost another $11.1 billion since.

These policies were evidently inspired by the magic fairy theory of pharmaceutical economics; namely that if you demand billions of dollars from drug manufacturers, a magic fairy will simply give them the money to comply. Alas. Instead, manufacturers' need to come up with money totaling nearly $100 billion simply means an increase in their costs of operations that must ultimately be priced into their products and paid by drug purchasers — that is, you. Now that these costly policies are embedded in the industry's pricing policies, the need for further increases has abated and so has the overall rise in drug prices.

There are continual calls for the government to "do something" about drug prices. Perhaps instead it should just undo something.