Unintentional Predatory Pricing via Government Price Control[1]

Bienvenido "Nonoy" Oplas, Jr. [2]

1. Timetable for drug price control implementation

The drug price control or maximum retail price (MRP) in the Philippines will be implemented starting August 15 to September 15, 2009 without penalty. By September 16, penalties and sanctions will be imposed for erring drugstores that still sell at the old price and not on the new prices under either voluntary price cut (covering 16 molecules) and mandatory price cut (covering 5 molecules) under Executive Order 821, dated July 28, 2009. Nearly 100 drugs from 21 molecules total are covered.

The term "voluntary" price cut is actually not precise because those drugs under the 16 molecules that the Department of Health (DOH) identified, were to be issued mandatory price cut anyway if the drug manufacturers will not bring down their prices by at least 50 percent. There is a political threat involved. So it is not the typical unilateral price reduction because of competition, but price reduction because there will be a coercive EO that will fall upon those drugs if the manufacturers will not cut the prices by 50 percent or more.

After 3 months or so of the price control experiment, the DOH will review its implementation. If it worked well as planned, meaning more poor people can

[1] Expanded version of a draft presented at the forum on "Government Price Control of Medicines", sponsored by the Philippine College of Physicians (PCP), Annabel's Restaurant, Quezon City, August 4, 2009.

[2] President, Minimal Government Thinkers, Inc.

Special thanks to my fellow speakers in the forum, Mr. Willy Fabroa of PCPI and Mr. Eufe Tantia of PHAP, for their articulate discussion of the subject. Thanks also to Atty. Joey Hisamoto of PCP Secretariat for inviting me to the forum, and Dr. Aimee Andag-Silva, PSEM, for her work as forum moderator.

buy those essential drugs and there is some improvement in health outcomes among Filipinos, the DOH will likely recommend extension for several months more of the price control program. It might even recommend expanded coverage to more molecules and more drugs. But if the results are not positive, like some important drugs become unavailable to the patients, there is weakening if not bankruptcy of some local pharma companies, a decline in investment and credit ratings of the country and so on, then the DOH can recommend to the President to discontinue the program.

2. Early signals and initial results before the August 15 implementation

One of the projected effects of declaring drug price control is that the affected multinational pharmaceutical companies will be hit hard as their drugs covered by the price control are usually among their most popular, most saleable and hence, most profitable products. With those drugs to experience massive forcible price cut, then their financial bottom line will be adversely affected.

Such thinking is often driven by ideological hatred for multinational corporations and capitalism in general, and the pharmaceutical companies in particular. There is a persistent public belief that those multinational pharma companies are here only to make money and huge profit at the expense of the sick and poor patients in developing countries like the Philippines. Thus, government intervention – like price control regulation – in favor of the poor is needed.

However, there are signs showing that some or many of the local, Filipino-owned generics manufacturers and traders, would be the ones that will be hit harder than the multinational pharmaceutical companies. Some leaders of the local pharma industry through the Philippine Chamber of Pharmaceutical Industries (PCPI) emphasized several times during the various meetings of the DOH Advisory Council on Price Regulation, that price control on the most saleable drugs of innovator multinational pharmaceutical companies will adversely affect them too. They feel that some of the local companies might be forced to close shop if the price control program will linger for long.

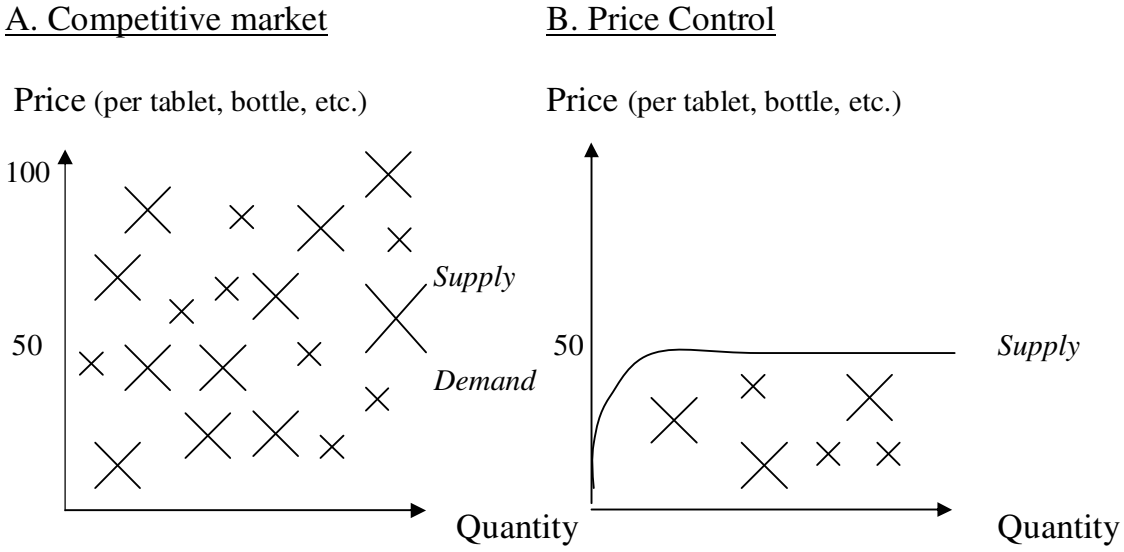
Why and how will this happen?

3. Price setting under a competitive market vs. price-controlled market

Under a competitive market, different manufacturers (innovators and generics) produce one or more drugs on the same generic category, and each drug has a particular quality with a particular price. Then various consumers and patients adjust to those prices and quality. Consumers rich and poor alike reach out for the "better quality" (more effective, more disease killer) ones even if the price may be high, depending on how serious their health condition is. What we have is a market with plenty of "equilibrium prices" per generic category or per drug molecule, such as the one depicted in case A below. The upward-sloping lines represent supply curves while the downward-sloping lines represent demand curves.

When a price control is imposed by the government, price ranges and price competition above the maximum retail price (MRP) are removed or abolished. We will have a flat, horizontal supply curve at a price set by the government, and not by the various manufacturers competing with each other. And only price competition along this horizontal supply curve, or below it, are permitted, as in case B below.

Chart 1: Price setting and price competition among different drugs by different manufacturers in the same generic category



So there is a "hollowing out" and emptiness of price segmentation and differentiation above the horizontal supply curve. The level of competition among different manufacturers and their respective drug products is reduced and shrunk. Suddenly, the local manufacturers who used to sell at 30 percent or 40 percent lower than the products of multinational manufacturers under price

control regulation find themselves that they are now the "expensive" sellers. And the multinationals that used to cater to the richer consumers are now "raiding" a portion of the niche market of local manufacturers as the poorer consumers of the latter will now move to buy the "more affordable" products of the former.

It will be a big headache for some local pharma companies how much downward price adjustments they can take. If their cost of production and marketing is low, then further price cut will not be a problem.

4. Economies of scale and country shares of pharma revenues

Multinational pharma companies have economies of scale in manufacturing and marketing of their products. Production of certain drugs is done in just one manufacturing plant somewhere in the world and marketed and distributed worldwide, creating huge economies of scale. Local pharma companies, on the other hand, only have the Philippines as their production base. They do not have economies of scale, compromising their capacity for big price adjustment downwards if needed.

In addition, the multinationals' revenue from the 10 member-countries of ASEAN (Association of South East Asian Nations) average only around 3 percent of their global revenues in 2007. For the whole of Asia except Japan, they got only around 8 percent of their global revenues. The bulk of their revenues and profit come from the rich countries of North America, Europe and Japan.

The Philippines? Maybe about 0.5 percent or less of their total global revenues on average. Thus, the multinationals can afford to endure temporary losses from selling some of their price-controlled drugs in the country because such losses can be more than recouped from their revenues elsewhere, especially in rich countries. The local and Filipino-owned pharma companies though, except for a few, have no other markets to sell to, and have only limited number of products to sell. So when some of those already limited number of products are hit by huge price cut from competing firms, closure of operation is certainly one possibility. This possibility seems to have not crossed the minds of the politicians and some DOH officials who designed the price control regulations and EO.

5. The multinational pharma, can the Philippines afford to do away with them?

This is a question that crops up from time to time, in the minds of the public. The answer seems to be a clear No. Per PCPI record, out of the 607 essential molecules, the local pharma companies produce only about 200, so two-third (2/3) of total essential molecules are still being supplied solely by the multinationals in the country.

Transfer of technology from the multinationals to the local pharma companies happens after the drug patent of the former expire, allowing the latter to develop their own brands and generic versions of the off-patent drugs.

But most importantly, multinationals are usually the research-based companies that produce new and more innovative drugs. Diseases evolve, and people are becoming more demanding, they want to recover from their diseases within one to three days whenever possible, and not one week or one month or one year. Hence, the necessity of continued development and invention of more powerful, more revolutionary drugs that only innovator pharma companies can do.

6. New legislation: create a price control body or remove taxes on medicines?

Some authors of the version in the House of Representatives are proposing to revise the one-year old Cheaper medicines law (RA 9502) to create a drug price control body, replace the current system where the DOH Secretary makes the recommendation, the President signs an Executive Order issuing price control on certain drugs.

This is wrong and ill-advised. We still have to see how the current price control program will fare. If it is indeed working well, the benefits far outweigh the costs, then the price control regime can be extended and the coverage of the molecules and drugs can be expanded. But if the results are not good, then the price control program should be discontinued after a 3 to 6 months projected duration of the program.

What the legislators as the House of Representatives should prioritize, is to remove the various taxes and fees on medicines. Most of those medicines by the multinationals that are deemed expensive are imported. Also those medicines from India that are deemed cheap. Upon landing in Philippine soil of those medicines, the cheap becomes expensive and the expensive becomes more expensive. How?

There are at least 5 different taxes and fees imposed on medicines alone: import tax (about 5 percent), import processing fee, import documentary stamp tax, local government tax, and value added tax (VAT, 12 percent). The VAT is imposed as (landed price + various taxes) x 12% = VAT. In a sense, VAT is a tax on a tax, it is a tax on import tax, a tax on documentary stamp tax, etc.

Industry estimates say that those different taxes and fees comprise about 20 percent of the retail price of medicines. So government itself is responsible for expensive medicines by at least 20 percent. Remember that this is government taxation on medicines alone, on the product alone. Government also taxes the pharma companies, the importers and distributors, and the drugstores.

Government thinking that medicines are like beer, cigarettes and hamburger that must be taxed as much as possible is both parasitic and hypocritical. Government says it wants cheaper medicines but it actually contributes to more expensive medicines. So the sooner that the legislators can correct this by removing – at least drastically reducing – the various taxes on medicines, the sooner it can correct the parasitic and hypocritical practice.

7. Unintentional predatory pricing, a by-product of government price control

Predatory pricing is supposed to be an ugly practice by some companies that want to monopolize or establish an oligopoly in a particular sector that is currently teeming with lots of players and competitors. Thus, the government comes in to disallow certain price cut initiatives by such companies in order not to cause early demise of many smaller competing firms.

Government-imposed price controls though, has the equally ugly result of institutionalizing and legalizing the ugly practice of predatory pricing. By forcing some multinationals to bring down some of their more popular, more saleable drugs, the government in effect has imposed unfair pricing among competing players that can possibly result in the demise of some local pharma companies which do not have enough leeway in introducing even further price cuts.

This affirms Newton's third law of motion: "for every action, there is an equal, opposite reaction." Translated to economic policy making: for every government intervention, there is an equal, opposite result that needs another intervention.

This does not sound right.

8. Conclusions: monitor objectively the price control program and see the necessity for its extension or discontinuation

Lest we be misunderstood, while we oppose the philosophy of government intervention in price setting of anything, the laws (RA and EO) are already there, so we have to respect their implementation.

What the public can do is to objectively monitor and assess the short-term results and long-term implications. It is ultimately the public and the consumers, not the politicians, who will suffer from lack of competition among players and lack of choice among drugs, if some players will pull out or go bankrupt, and/or some drugs are withdrawn from the market because of unrealistic pricing imposed by the State.

So long as alternative drugs, so long as generic competitors are present, then public welfare is assured. Some may say that even the cheapest generics are still unaffordable for them. Well there is a price to taking care of our loved ones. And here we reiterate our belief that health care is first and foremost a personal and parental, also corporate responsibility to their employees. People should not over-drink, over-smoke, over-eat fatty foods, over-sit and have sedentary lifestyle, over-fight and have stab wounds occasionally, and so on, then demand that quality health care is their "right" and a government responsibility.

Government responsibility in health care is only secondary to personal and parental responsibility. Government should come in and impose stringent and radical intervention in cases of disease outbreak and similar health emergencies. Otherwise, it should step back, it should not over-tax medicines and health enterprises. Allow and encourage more competition among them, so that the public will have more choices. More choice means more freedom.

Annex: Some news in international papers about the drugs MRP

(1) Philippines President Arroyo Orders Drug Price Controls

JULY 28, 2009, 8:14 P.M. ET, Wall Street Journal

By James Hookway

http://online.wsj.com/article/SB124879732286587201.html?mod=googlenews_wsj

(2) OPINION ASIA

JULY 28, 2009, 12:30 P.M. ET

Drugs and Manila

The Philippines' imposition of price controls
http://online.wsj.com/article/SB10001424052970203946904574301641559126508.html

The war on intellectual property has a new front: the Philippines. Yesterday President Gloria Macapagal Arroyo announced the imposition of price controls on drugs for the first time in the country's history. This might make for good politics, but it's bad economics.

(3) Research and Markets:
The Philippine Pharmaceutical Market Was Valued At US$1.4 Billion in 2008, Which Was Equal to Nearly US$15 Per Capita
http://www.reuters.com/article/pressRelease/idUS132005+29-May-2009+BW20090529

Fri May 29, 2009 9:41am

DUBLIN--(Business Wire)-- Research and Markets (http://www.researchandmarkets.com/research/063ddd/the_pharmaceutical) has announced the addition of the "The Pharmaceutical Market: Philippines" report to their offering.