The Economic Impact of Parallel Trade in the Pharmaceutical Industry

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Overview

- The “standard” economic analysis of parallel trade
- Why is the pharmaceutical industry special?
- Analytical framework
- Impact of parallel trade
- Imperfect competition between traders exacerbates inefficiency
- Summary

Market Integration vs Consumer Welfare

Who are the consumers of pharmaceutical products?

Does the protection of parallel trade enhance consumer or social welfare

Price discrimination and output

Impact of parallel trade on governmental policies relating to social and industrial policy

There is no policy basis for introducing an *a priori* rule protecting parallel trade

- The value of parallel trade as a tool for achieving market integration depends on the economic and regulatory context.
- An *a priori* rule protecting parallel trade is not welfare enhancing and may run counter to other equally important goals of the Treaty.

The “standard” economic analysis of parallel trade

- A firm selling in several countries would in general like to sell at different prices
  - Different demand/supply/competition conditions
- Parallel trade imposes price uniformity
  - This uniform price is at “average” level
    - Some consumers lose while others gain (firms lose)
    - Overall impact generally ambiguous

Why is the pharmaceutical industry special?

National regulations

- Negotiations between firms and customers
  - Bilateral
    - The customers are the governments
    - Prices are regulated at national level
  - Multi-dimensional
    - Prices
      - current products / short-term gains
      - private gains
    - R&D
      - future products / long-term gains
      - public good

Why is the pharmaceutical industry special? (Cont'd)

- In this context, parallel trade
  - Reduces flexibility in price/R&D bilateral negotiations
  - Constrains policies that promote R&D

➧ Can adversely affect *all* customers (and the firms)

Analytical framework

- Regulated prices determine “contributions” to R&D
  - Level of R&D driven by level of product prices
    - Ex ante (incentives)
    - Ex post (retained earnings)
  - Overall R&D is the sum of national contributions (public good)

Analytical framework (Cont'd)

- National preferences over price/R&D trade-offs

Intrinsic differences in preferences

– Tighter budget constraints in Spain
– Larger importance of industry in the UK

➢ Spain more "price-oriented" than the UK

Analytical framework (Cont'd)

- In the absence of parallel trade

  each country chooses a price and/or a contribution to R&D

  – Lower prices (and contributions to R&D) in Spain

    - each country trades off the value of its contribution to R&D against the cost of the price needed to support it
    - since UK puts more emphasis than Spain on R&D, it chooses higher price and R&D

  – Insufficient R&D (free-riding)

Impact of parallel trade

- The lower Spanish price prevails
  - If the UK does not adjust its price, direct sales in the UK are replaced with imports from Spain
    - the contribution to R&D is driven by Spanish lower prices
    - the UK effective price is the Spanish price, augmented by the cost of parallel trade
  - the UK can avoid “paying” for the cost of parallel trade by lowering its price
    - still, the maximal price is the Spanish price, augmented by the cost of parallel trade

⇗ as long as Spanish prices do not change too much, the UK policy is constrained

Impact of parallel trade (Cont'd)

- As long as Spanish prices do not change too much,
  - UK welfare decreases
    constraint on price/R&D policy
  - Spanish welfare also decreases
    does not benefit as much as before from UK R&D policy
  - Third countries, too, are adversely affected
    - suffer from reduced UK contribution to R&D
    - might be constrained on their own price/R&D policy

Impact of parallel trade (Cont'd)

- The overall evolution of R&D goes in wrong direction
  - Initial level already insufficient
  - Parallel trade further reduces R&D

- *parallel trade does not lead to "market integration", but rather to a uniform alignment on the lowest levels of R&D contributions*
- *adversely affects all countries*

Imperfect competition between parallel traders exacerbates inefficiency

- Operates a transfer from consumers (or taxpayers) to traders

  Paid by the UK government, does not contribute to finance R&D

  - Limits UK government's ability to promote R&D
    Reduces UK government's incentive to promote R&D

Summary

- Governments have different objectives
  - Some governments focus more on low prices
  - Others are more interested in the development of new products

- Parallel trade limits governments freedom of action
  - imposes uniform prices

  ⇗ reduces the efficiency of negotiations
    - hurts "R&D-oriented" governments
      cannot finance as much R&D as they would like to
    - hurts the other governments
      no longer benefit from the R&D financed by the first ones

Summary (Cont'd)

- Parallel trade unlikely to lead to "market integration"
  - more likely to lead to a alignment on lowest prices and R&D investments
  - multilateral negotiations would be more effective
- Adverse impact reinforced by the public-good nature of R&D

Summary (Cont'd)

- Adverse impact reinforced by imperfect competition between parallel traders
  - more difficult for governments to resist pressures from parallel trade
  - governments' policies to promote R&D are further discouraged
  - transfer from customers to traders (no contribution to R&D)

Agreements limiting parallel trade can benefit consumers

- End users in exporting countries benefit through adequate supplies and speedy supply of new products.
- Importing Member States that wish to encourage R&D benefit.
- Exporting Member States that wish to reduce their health care budgets benefit
- End users and governments throughout the Community benefit from new products resulting from R&D.

Subsidiarity

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