

The Benefits to State Governments from the Free Market Drug Act

By Dean Baker¹

October 29, 2004

CENTER FOR ECONOMIC AND POLICY RESEARCH 1611 CONNECTICUT AVE., NW, SUITE 400
WASHINGTON, D.C. 20009 (202) 293-5380 <WWW.CEPR.NET> EMAIL: CEPR@CEPR.NET

¹ Dean Baker is the co-director of the Center for Economic and Policy research. Patrick McElwee, David Rosnick, and Diane Schwartz provided research assistance and or comments on earlier drafts of this paper.

Health care costs are the most rapidly growing share of state budgets. Since 1990 state and local spending on health care has risen at a 7.3 percent annual rate, far above the rate of nominal GDP growth. Health care costs are projected to rise at an even more rapid 7.9 percent annual rate over the next decade.² State and local government spending on prescription drugs has increased more rapidly than health care spending in general, rising at a 13.4 percent annual rate since 1990. It is projected to rise at a 10.9 percent annual rate over the next decade.³ By 2013, the Center for Medicare and Medicaid Services (CMS) projects that annual state and local government spending on prescription drugs will be \$49.1 billion compared to \$17.4 billion in 2003.

Such spending will impose a substantial burden on state budgets, with the growth in projected drug spending taking up nearly 3 percent of the increase in state budgets over this period. The projected increase in state and local government spending on prescription drugs (in excess of the general inflation rate) is approximately four times the present level of state and local government subsidies for child care.

Given this baseline projection for growth in drug spending, states have a substantial interest in reducing the cost of prescription drugs. In order to reduce the cost of prescription drugs, many public figures have suggested that the federal government negotiate prices with drug companies in the same way as governments in other wealthy countries. While this route will reduce drug costs, many of the problems of the current system will remain since it continues to rely on government granted patent monopolies to finance drug research.⁴ In addition, if the government is setting drug prices, it is effectively directing research (companies will invest where government set prices allow them to earn the highest profit), albeit not in a conscious manner

An alternative method for reducing drug prices is to change the mechanism for financing drug research. Currently, approximately half of all biomedical research in the United States is financed by the federal government through the National Institutes of Health. If this spending was doubled, public funding could replace the research spending currently supported by the patent system. And, since the research was paid directly by the public sector, the resulting patents could be placed in the public domain, so that new drugs could effectively be sold as generics. If drugs are sold as generics, their prices

² These figures are taken from the Center for Medicare and Medicaid Services (CMS) Projections for National Health Expenditures, Table 3 [<http://www.cms.hhs.gov/statistics/nhe/projections-2003/t3.asp>].

³ CMS Projections for National Health Expenditures, Table 11 [<http://www.cms.hhs.gov/statistics/nhe/projections-2003/t11.asp>]. This growth path may be somewhat slowed by the passage of the Medicare prescription drug benefit in 2003, but the effect will be limited since the law provides for a mechanism to claw back most of the savings to the states.

⁴ There are a standard set of objections that economists raise any time that prices exceed the marginal cost of production, as is the case when the government grants patent monopolies for prescription drugs. Most of these inefficiencies are associated with rent seeking behavior. This includes advertising and marketing, which is sometimes misleading or even false, withholding unfavorable research findings, and hiring lawyers and lobbyists to extend the duration and scope of patent protection. When prices rise high enough, it is also likely to lead to a black market in drugs (see Baker 2004, Financing Drug Research: What Are the Issues? [http://www.cepr.net/publications/intellectual_property_2004_09.htm] and Baker Chatani 2002, Promoting Good Ideas on Drugs: Are Patents the Best Way? [http://www.cepr.net/promoting_good_ideas_on_drugs.htm]).

would be a small fraction of what they are presently. Drugs are almost always cheap to produce. They are expensive only because the government grants drug companies a patent monopoly that excludes competition.

This is exactly the path proposed by the Free Market Drug Act which was recently introduced in Congress. It would appropriate approximately \$25 billion a year for financing prescription drug research carried through by a series of competing research centers. (Savings from lower drug costs under the new Medicare prescription drug benefit should easily offset the cost to the federal government of additional research spending.) All research findings would be promptly made public (drug companies often conceal findings to avoid helping competitors) with the resulting patents placed in the public domain.⁵

If this bill was passed, the cost of prescription drugs should fall rapidly through time, as the new system carries more drugs through the Food and Drug Administration's approval process, and then makes them available to be sold as generics. Competition from generics will also bring down the price of many drugs that still enjoy patent protection. In fact, the threat of competition from generics is likely to prompt drug companies to lower their prices in advance of competitive drugs actually being developed, since there would be less cause to research a new drug in an area where the existing drugs are already being sold at a reasonable price. For this reason, it is likely that the Free Market Drug Act would lower drug prices quickly after it was enacted.

We constructed a set of projections to show the potential impact that the Free Market Drug Act would have on state budgets. Table 1 shows the savings to state governments on drug expenditures compared with the baseline projections from CMS. The projections assume that states save 10 percent of their baseline spending in 2009, 20 percent in 2010, 30 percent in 2011, 40 percent in 2012 and 50 percent in 2013. (The construction of these projections is explained more fully in the appendix.) The projection of 50 percent savings for 2013 is probably still less than the full impact of having all drugs sold in a competitive market. Generic versions of drugs often sell for less than 30 percent of the brand version. And, in recent years Indian drug manufacturers have been able to profitably sell generic versions of AIDS drugs, that met the highest safety standards, for less than 5 percent of the price for which the brand drug was sold in the United States. Clearly free market competition will lead to drastically lower prices for prescription drugs

⁵A fuller description of the bill, H.R. 5155, can be found on the website of Representative Dennis Kucinich, who is the author of the bill [<http://www.house.gov/kucinich/issues/freemarketdrugact.htm>].

Table 1**State by State Savings With the Free Market Drug Act**

	2009 (millions of current dollars)	2010	2011	2012	2013	Total 09-13
Alabama	\$42.0	\$92.7	\$152.7	\$226.8	\$302.5	\$816.7
Alaska	10.6	23.5	38.6	57.4	76.6	206.7
Arizona	49.7	109.5	180.5	268.0	357.6	965.3
Arkansas	30.4	67.0	110.5	164.1	218.9	590.9
California	366.0	807.1	1,329.8	1,974.8	2,634.8	7,112.4
Colorado	30.8	68.0	112.0	166.3	221.9	599.1
Connecticut	52.2	115.1	189.6	281.6	375.7	1,014.2
Delaware	11.1	24.5	40.4	60.0	80.1	216.3
District of Columbia	12.5	27.7	45.6	67.7	90.3	243.7
Florida	138.7	305.9	503.9	748.4	998.5	2,695.3
Georgia	90.8	200.1	329.7	489.7	653.4	1,763.7
Hawaii	13.7	30.1	49.7	73.7	98.4	265.6
Idaho	11.0	24.2	39.9	59.3	79.1	213.6
Illinois	127.4	281.0	463.0	687.6	917.5	2,476.7
Indiana	57.3	126.4	208.2	309.2	412.6	1,113.8
Iowa	36.0	79.4	130.9	194.4	259.4	700.1
Kansas	27.0	59.5	98.0	145.6	194.2	524.3
Kentucky	56.7	125.0	205.9	305.8	408.0	1,101.4
Louisiana	67.0	147.7	243.3	361.4	482.2	1,301.6
Maine	19.6	43.2	71.1	105.6	140.9	380.3
Maryland	56.3	124.1	204.5	303.6	405.1	1,093.6
Massachusetts	118.8	262.0	431.7	641.1	855.3	2,308.8

Michigan	106.0	233.7	385.0	571.8	762.9	2,059.4
Minnesota	59.3	130.8	215.6	320.1	427.1	1,153.0
Mississippi	36.8	81.2	133.8	198.7	265.1	715.7
Missouri	70.5	155.5	256.3	380.6	507.8	1,370.7
Montana	8.3	18.3	30.1	44.7	59.6	160.9
Nebraska	18.9	41.6	68.6	101.9	135.9	366.9
Nevada	12.5	27.6	45.5	67.5	90.1	243.2
New Hampshire	14.0	31.0	51.0	75.8	101.1	272.9
New Jersey	111.7	246.3	405.8	602.6	804.0	2,170.3
New Mexico	23.2	51.2	84.4	125.3	167.2	451.4
New York	477.0	1,051.9	1,733.1	2,573.7	3,433.9	9,269.5
North Carolina	90.5	199.6	328.9	488.4	651.7	1,759.1
North Dakota	6.8	15.0	24.7	36.7	48.9	132.1
Ohio	124.2	273.9	451.4	670.3	894.3	2,414.2
Oklahoma	31.8	70.2	115.7	171.8	229.2	618.6
Oregon	35.9	79.3	130.6	194.0	258.8	698.6
Pennsylvania	161.5	356.1	586.7	871.4	1,162.6	3,138.3
Rhode Island	18.9	41.7	68.7	102.0	136.1	367.4
South Carolina	47.1	103.9	171.2	254.2	339.2	915.7
South Dakota	7.4	16.3	26.8	39.8	53.1	143.4
Tennessee	76.7	169.1	278.7	413.8	552.1	1,490.4
Texas	192.7	424.9	700.0	1,039.6	1,387.0	3,744.1
Utah	16.2	35.7	58.8	87.3	116.5	314.6
Vermont	8.8	19.4	32.0	47.4	63.3	170.9
Virginia	55.0	121.2	199.7	296.6	395.8	1,068.3
Washington	81.7	180.2	296.8	440.8	588.2	1,587.7
West Virginia	22.9	50.5	83.2	123.5	164.8	444.8
Wisconsin	63.4	139.8	230.4	342.1	456.4	1,232.1
Wyoming	4.7	10.4	17.2	25.5	34.0	91.9

The projections in Table 1 indicate that most states would experience substantial savings under the Free Market Drug Act. For example, Michigan would save \$106 million in 2009. Its annual savings would rise to \$763 million by 2013, and its total savings over the five year period would be \$2,059 million. Since its current spending is the highest, New York would have the largest savings, seeing a reduction of drug costs of \$477 million in 2009, rising to \$3,434 million by 2013. Its total saving over the five year period would be \$9,270 million.

While the Free Market Drug Act raises many important issues which deserve serious debate, there can be little doubt that the prospect of having prescription drugs sold in a competitive market offers large savings. A substantial portion of these savings would accrue to state and local governments. They clearly would benefit enormously from having drugs sold in a competitive market.

Appendix

The calculations of savings in table 1 are derived from the CMS estimate for state and local government spending on prescription drugs for the years 2009 to 2013, Projections for National Health Expenditures, Table 11

[<http://www.cms.hhs.gov/statistics/nhe/projections-2003/t11.asp>]. Spending was apportioned between states based on shares of 2002 state health care spending. This level was calculated based on 2002 spending on Medicaid and SCHIP. The data for state Medicaid and SCHIP spending was taken from the Kaiser Family Foundation's "Statehealthfacts.org" (for Medicaid [<http://www.statehealthfacts.org/cgi-bin/healthfacts.cgi?action=compare&category=Medicaid+%26+SCHIP&subcategory=Medicaid+Spending&topic=Total+Spending%2c+2002#tabletop>] and for SCHIP [http://www.statehealthfacts.org/cgi-bin/healthfacts.cgi?action=compare&category=Medicaid+%26+SCHIP&subcategory=SCHIP&topic=SCHIP+Expenditures&link_category=&link_subcategory=&link_topic=&printerfriendly=0&viewas=table]). In addition, 2002 health care spending levels for public employees was imputed based on 1999 spending levels. The 1999 spending levels were taken from the Milbank Memorial Fund's "1998-1999 State Health Care Expenditure Report," Table 18 [<http://www.milbank.org/1998shcer/nastab18.html>]. The calculations assumed that state health care spending on public employees between 1999 and 2002 rose at the same pace as national health spending overall.