

MICROECONOMICS AT WORK EXERCISE

HOW THE ACTIONS OF GOVERNMENT CAN AFFECT PRICE

REFERENCE: ‘Get the FDA out of the way, and drug prices will drop’ (by Gary S. Becker), *BusinessWeek*, 16 September 2002, p. 16.

CHAPTER RELEVANT TO THIS EXERCISE: Chapter 3.

OVERVIEW

The price of medicines (drugs) has increased in recent years. In the context of an increased demand for medicines (partly a consequence of an ageing population, *itself* partly a consequence of the development of new drugs and longer average life expectancy), the *total expenditure* ($p \times q$) on drugs has also increased. This expenditure has become a larger and larger part of household budgets and has led to concerns being expressed among consumer groups, and especially the elderly, about the price of drugs.

Prices could be lowered by introducing *price controls* (i.e. establishing a *price ceiling* by law). However, one consequence of such action would be to lower the revenue of drug companies and force them to cut costs. One of their major costs is research and development (R & D) associated with developing new drugs. This policy might therefore have the effect of slowing the development of new drugs.

A *better* way of curbing costs (so it is argued in this article, by a prominent US academic economist) would be to eliminate one of the requirements imposed on drug companies by the Food and Drug Administration (FDA), an arm of government, that increases the costs of development incurred by firms. Under present law, drug companies are required to be able to prove, through clinical trials, that drugs are *effective* in treating a specific disease or condition. This can be very expensive and, by increasing the cost of production and supply, the price is increased beyond what it would otherwise be.

QUESTIONS

1. How and why is it that the price of drugs has become a public issue?
2. What would be the consequence of imposing a *price ceiling* on the cost of drugs to consumers (i.e. of introducing *price control*)?
3. What is meant by the ‘efficacy requirement’ imposed on drug companies by the FDA? How does this affect the price of drugs?
4. How would removal of the efficacy requirement affect the price of drugs? Is its removal desirable?

5. What associated policies are suggested to accompany removal of this requirement?