Bargaining and International Reference Pricing in the Pharmaceutical Industry

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Abstract

The United States spends twice as much per person on pharmaceuticals as European countries, in large part because prices are higher in the US. This fact has led policymakers in the US to consider legislation for price controls. This paper assesses the effects of a hypothetical US reference pricing policy that would cap prices in US markets by those offered in Canada. We estimate a structural model of demand and supply for pharmaceuticals in the US and Canada, in which Canadian prices are set through a negotiation process between pharmaceutical companies and the Canadian government. We then simulate the impacts of the counterfactual international reference pricing rule, allowing firms to internalize the cross-country impacts of their prices both when setting prices in the US and when negotiating prices in Canada. We find that such a policy results in a slight decrease in US prices and a substantial increase in Canadian prices. The magnitude of these effects depends on the particular structure of the policy. Overall, we find modest consumer welfare gains in the US but substantial consumer welfare losses in Canada. Moreover, we find that pharmaceutical profits increase in net, suggesting that reference pricing of this form would constitute a net transfer from consumers to firms.

Keywords: Pharmaceuticals, Reference Pricing, Most Favored Nation Clause, Bargaining, Empirical Industrial Organization.

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