



# THE FREE MARKET FOUNDATION

of Southern Africa

progress through freedom

## Health Policy Unit

### Comment to the Department of Health in response to Government Gazette No. 28214 of 11 November 2005 (Notice No 2007 of 2005).

#### Determination of a maximum logistics fee

The Free Market Foundation (FMF) is a registered Non-Profit organisation that promotes the open society philosophy, the rule of law, and free market policies based on sound economic principles. It works for an economic and business environment that will facilitate the achievement of high economic growth in Southern Africa.

#### 1. The economic implications of a logistics fee cap

A logistics fee cap, as with any form of price control, will not and cannot protect consumers or ensure lower drug prices. Governments have for many years attempted to control prices and in every case the regulations have interfered with the normal market process, have reduced competition and ultimately have harmed the consumer. Consumers are most effectively protected by open competition, which gives the maximum power to consumers to punish or reward firms based on their performance.

Government's stated objective is to increase access to essential medicines to low-income individuals and since these individuals generally live long distances from the major urban centres it will discourage distributors and wholesalers from servicing outlying areas if a cap on the logistics fee is introduced. Furthermore, the longer the policy is in force, the larger the misallocation will be. More importantly the government's attempt to control economic outcomes is based upon a small set of preferences rather than upon the general preferences of all the market participants. As a result, preferences of individuals are less co-ordinated than they would otherwise have been.

Government micro management of medicine distribution through the introduction of a logistics fee cap be expected to have a number of negative effects and unexpected consequences. Price controls are normally promoted and devised under the guise of assisting the poor and alleviating poverty. Yet in almost every case it is the poor that suffer most from price controls. In South Africa and most other countries, it is the rich that have access to the high volume, low mark-up retailers that can offer cheaper goods in large urban areas. The poor generally shop in low-volume, high mark-up establishments in the townships simply because they are conveniently located.

Indeed, rural areas or townships are typically not well served by large high volume retailers and pharmacies. Rather, poor consumers and patients purchase medicines (and indeed all manner of other goods) from small-scale retailers that may have high margins due to their low volume of trade. Yet consumers are acting rationally when they purchase goods from these retailers because they apparently choose to pay a higher price for convenience. Their alternative would be to travel long distances (thereby incurring travel costs) to access medicines from the high volume, low mark-up retailers in urban centres. The introduction of a maximum fee for logistics will do considerable harm to consumers by undermining their choices.

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In addition to penalising small volume retailers and businesses and harming poor consumers, price controls act as barriers to entry. In many cases price controls are tolerated or even welcomed by large established businesses because it keeps competition out of the industry. If prices are regulated downwards to a level where the high volume, low mark-up firm can still remain in business, no other kind of business will be able to compete. Not only does this harm emerging and smaller businesses, but it reduces consumer choice and therefore welfare.

## **2. Relevant Regulation**

The Minister, on recommendation of the Pricing Committee, must determine a maximum logistics fee where, in the opinion of the Minister, such a determination is necessary to promote or protect the interests of the public in -

- (i) Ensuring reasonable access to affordable medicines
- (ii) The realization of the constitutional right of access to health care services contemplated in section 27 of the Constitution
- (iii) The efficient and effective distribution of medicines and Scheduled substances throughout the Republic

## **3. Single Exit Price (SEP) and Maximum Logistics Fee (MLF)**

The notion of a Single Exit Price that carries right through the supply chain requires that manufacturers and importers of pharmaceuticals have to incorporate into their prices all costs, including the costs of distributing and delivering their products to the final user. Such a requirement does not allow for the differences that exist across the entire spectrum of possibilities such as the physical location of the patient, the value of the medicine, the cost of maintaining certain drugs at constant temperatures, the shelf life of a drug, and the multiplicity of other factors involved in getting a drug from the manufacturer or importer through the entire supply chain to the patient at the end of the line.

The SEP has already resulted in a disruption of the supply chain and a loss of service to some patients. If government sets a maximum logistics fee (MLF) even greater disruption will occur because the single-size-fits-all approach will again cause disruption of the existing supply chain and result in a loss of some of the links in the chain and consequently a loss of service to some patients. Once again the patients who are at greatest risk of losing services are those in the lowest income groups living in the poorest communities.

Many manufacturers have handed over distribution logistics to specialist distribution firms. The distributors warehouse stock, issue invoices and deliver products on behalf of manufacturers and importers in return for a logistics fee.

Wholesalers of pharmaceuticals tend to add additional services, such as granting credit, providing more frequent deliveries and carrying a wider range of products with which to service their suppliers such as wheelchairs and other devices required by the infirm. As a result of the SEP, some wholesalers have been forced to purchase a large percentage of their pharmaceuticals from distributors and sell these products to their clients at zero profit. They do this in order to fulfil their role of being a 'one-stop-shop' for their clients. Many of these wholesalers grew their business during the apartheid years by supplying medicines to doctors, pharmacies, and other healthcare facilities in what were then "no-go" areas for large firms. They continue to provide a valuable service to healthcare providers and patients at the fringe – health care providers who require financing, frequent service delivery to outlying areas in small quantities for their patients, and other special services that larger firms cannot provide economically. Such service providers need a supplier who will supply all their needs in a single delivery, even if it requires searching for and purchasing items that are not regularly kept in stock.

In the setting of a MLF it is the patient at the end of the wholesaler supply chain that is most at risk of losing ready access to medicines, medical appliances and other healthcare services. These are the people at the fringe, just as the clients of the fast vanishing rural and community pharmacy were and are at the fringe of the supply chain. If the Department of Health is really concerned about the patient, and especially the poorest patients, it will make every effort in setting the MLF to ensure that it does not destroy the supply chain to the patient on the fringe.

#### **4. South Africa's medicine market**

It should be noted that South Africa has had two distinct markets for medicines and other controlled substances: the private sector and the state sector. Around 7 million South Africans are members of medical aid schemes and another 13.5 million have access of some description to healthcare in the private sector. The state sector is thought to provide healthcare services to a potential 33 million South Africans through the various state health facilities. As many people use both private and public health services, especially those that purchase traditional and other natural medicines but use public hospitals when they need surgery or specialised treatments, there is a considerable overlap.

The South African government's primary motivation for imposing an SEP and within it a logistics fee cap is to "ensure reasonable access to affordable medicines". However, to the extent that comparisons are possible, anecdotal evidence supports the fact that South Africa's private sector patients did not pay excessively high prices for medicines before the introduction of the SEP and the State purchases medicines at extremely low prices. Through the Co-ordinating Committee for Medical Procurement (COMED) tendering system for drugs, the government has been able to ensure that medicines for the state sector are around 35% lower than the World Health Organisation's (WHO) International Drug Price Indicator Guide (IDPIG). The IDPIG is compiled from actual international tender prices for the supply of generic drugs to agencies and vendors in poor and middle-income countries. Therefore, South Africa appears to be generally well served by its medicine suppliers and drastic government intervention such as the introduction of a SEP and maximum logistics fee cap seems to be unjustifiable.

The use of government policy to direct economic activity results in outcomes which many people find detrimental to their personal well-being. The end result of state interference in economic affairs is a mixture of policies, which will move the economy from one crisis to the next. Each political change in direction will alter relative prices so as to create new obstacles while at the same time destroying past successes. In addition to this, individual economic development will be hampered because of the false signals being given to the market. Indeed, reduced availability of drugs has in many countries exacerbated the parallel trade in drugs and black market for medicines. With products such as medicines it is often crucially important for the manufacturer to control the supply chain, ensure the product is safely transported and that it complies with the various regulations and safety instructions governing its use.

#### **5. Reduced Research and Development**

South Africa has traditionally been a favoured destination for drug companies to conduct research and development because of the sound scientific base, good infrastructure and range of different population groups with widely different social statuses in which to run trials. The drug price regulations are likely to reduce the incentive to conduct trials and invest in scientific infrastructure and knowledge as the ability to make appropriate returns on the investment is reduced. Drug companies, both local and foreign, have invested large sums in R&D in the past and this is likely to gradually fall away.

#### **6. Constitutional implications**

In terms of section 27(1)(a) of the Constitution of the Republic of South Africa everyone has the right to have access to health-care services. Section 27(2) stipulates that the state must take

reasonable legislative and other measures, within its available resources, to achieve the progressive realisation of this right. In response to this constitutional stipulation, government has committed itself to providing basic health care as a fundamental right, providing quality health care to all South Africans, and achieving a unified national health system.

While the rights mentioned in section 27 are limited by section 36, which makes them dependent on the availability of resources, there are different interpretations about what this means. There is a general assumption that the cost of all the socio-political rights contained in the Bill of Rights are to be borne by taxpayers “subject to the availability of resources”; however, one could argue that the real meaning of sections 27 and 36, taken together, is that government has a duty to adopt policies that will create an enabling environment for the most rapid possible growth of health-care services so that everyone has access to health care.

As there is compelling evidence that greater economic freedom provides the best environment for human development, the constitutional injunction could require the South African government to free the economy in order to comply with the constitution. Furthermore, it could be inferred that market forces must be allowed to operate in an unfettered manner so as to allow economic agents to determine the market price.

Section 36 (1) of the Constitution stipulates that “The rights in the Bill of Rights may be limited only in terms of laws of general application to the extent that the limitation is reasonable and justifiable in an open and democratic society based on human dignity, equality and freedom, taking into account all relevant factors, including...” four listed factors, the last of which is section 36 (1)(e) “less restrictive means to achieve the purpose”. An open and democratic society that has as its core values “the advancement of human rights and freedom” and supremacy of “the rule of law” (section 1 of the Constitution) requires a substantially different approach to health care than is currently contemplated by the Department of Health.

The essential characteristics of nationalised health services are that they are built on authoritarian compulsions and prohibitions. Patients are denied choice and health professionals are denied the right to freely practise their trades and professions. The measures necessary to establish such dictatorial regimes are contrary to the principles of an “open society”, “the rule of law” and “the advancement of human rights and freedom”, and as such may not survive a constitutional challenge. They are certainly contrary to the fundamental philosophy and spirit of the aspirational provisions of the Constitution.

A fully private health-care delivery system, unfettered by price controls, would meet all the requirements of the Constitution, including the right of every citizen to have access to health-care services. It would also meet the requirements of section 27(3) because no one will ever be denied emergency treatment in a private health system. The real health-care challenge is then to ensure medical treatment for those who are not able to pay.

## **7. International experience of price fixing**

The case of the United States government regulatory control over crude oil prices during the 1970s provides an excellent example of how such activities disrupt the market. By attempting to soften the initial rise in oil prices caused by the Arab oil embargo, regulators actually compounded the problem. Worse yet, the continuation of regulation during the 70s led to numerous private decisions, which would otherwise not have been made. Many of the resource movements prompted by the United States governmental policy would have to be reversed at a later date when the true market conditions became known.

In 1974 the Organisation of Petroleum Exporting Countries (OPEC) imposed a significant increase in the price of oil. Countries that had no domestically produced petroleum had little choice about energy policy – the price of oil and goods produced using oil had to rise. At the time of the price increase the United States produced about half of its domestic oil consumption, and Congress felt that it was unfair that the domestic producers receive ‘windfall profits’ from an uncontrolled

increase in price. So they instituted price controls on petrol. Each refiner was required to charge a price for petrol that was based on the costs of producing the petrol – which in turn was primarily determined by the cost of the oil that the refiner was able to purchase

The availability of cheap domestic oil in the States varied with location. In Texas for example, the refiners were close to the major source of production and thus were able to purchase large supplies of cheap oil. Due to the price controls, the price of Texas petrol was relatively cheap. In New York, virtually all oil had to be imported, and thus the price of petrol was quite high.

When you have different prices for the same product, it is natural for firms to try to sell at the higher price. Again the United States Department of Energy intervened to prevent the uncontrolled shipping of petrol from low-price regions to high-price regions. The result of this intervention was the infamous petrol shortages in the United States in the mid-seventies. Periodically, the supply of petrol in a region of the country would dry up, and there would be little available at any price. The free market system of supplying petroleum products had never exhibited such behaviour; the shortages were entirely due to the oil pricing system imposed by the government.

Similar consequences can be expected from price controls in the medicines market. Whenever price controls make the supply or delivery of medicines uneconomic the patients will be deprived of supply. Instead of a supply of medicines at slightly higher prices than those charged by higher volume and more conveniently located suppliers, the patient at the fringe will have no supply.

## **8. Conclusion**

Whenever government attempts to intervene in the market place by altering relative prices in order to achieve some particular end, the result is to redirect resources in perverse directions. In the case of the logistics fee cap the outcome is almost certain to add to the adverse effect on the distribution process in South Africa that has already resulted from the implementation of the SEP. The unintended consequence of this is that outlying areas will simply be neglected. The failure to service these outlying areas will result in reduced access and considering the fact that poor and marginalised individuals typically live in these areas, the new regulations will disproportionately affect the poorest of the poor.

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