



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).**

Comments on an increase in the Single Exit Price of medicines in terms of Regulation 8(1) of the above mentioned regulations

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. Introduction

Our grave concern for the negative consequences of imposing the Single Exit Price (SEP) impel us to call upon the Department of Health to reconsider its policy and repeal the regulation that requires the setting of a SEP. In our submission and oral evidence on the establishment of a SEP we predicted that small pharmacies, and particularly those in low-income and rural communities would be put out of business by the regulation, depriving patients of convenient service. Our prediction has proved to be accurate. The establishment of the SEP has caused untold harm; some of which will only become clear in the longer term.

The South African government has committed itself to reducing the cost of medicines and healthcare to patients in an attempt to improve the overall welfare and health of the nation. While the government may have good intentions in wanting to increase access to medicines and good quality healthcare, the imposition of a SEP is having many unintended consequences, which are reducing access to medicines and compromising South Africa's healthcare system.

Drug price regulations, as with any form of price control, will not and cannot protect consumers or ensure lower drug prices. Governments have for over 40 centuries attempted to control prices and in every case the regulations have interfered with the normal market process, have reduced competition and have ultimately 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 micro management of medicine distribution, wholesaling and retailing, and the imposition of price control on these sectors of the industry can be expected to have similarly negative effects and unexpected consequences. The most serious of these is likely to be the probability that small and outlying outlets, such as those in townships and rural areas, will be most severely affected.

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One of government's motivations for requiring a single exit price for medicines was to ensure that "South Africans have access to affordable, good quality medicine". Studies show that, to the extent that comparisons are possible, South Africa's private sector patients have not been paying excessively high prices for medicines and the State continues to purchase medicines at extremely low prices, which is confirmed both by anecdotal as well as empirical evidence. South Africa would therefore appear to be generally well served by its medicine suppliers and drastic government intervention such as the institution of price controls was unwarranted.

The FMF contends that high economic growth is regarded as the key to increasing incomes and living standards and reducing poverty. Empirical evidence demonstrates that an economic environment characterised by economic freedom is superior to any other in achieving these objectives. Not only does economic freedom result in the highest per capita incomes but it also improves all the other measures of human development, such as higher life expectancy, better literacy rates, improved sanitation, increased water sources and many other desirable social outcomes.

Price controls reduce the efficiency of any industry upon which they are imposed but also ultimately harm their intended beneficiaries. In the longer term, consumers and especially the poor in South Africa will be made worse off by the imposition of price controls and not better off. It is our grave concern for the consequences of the price control regulations that has impelled us to once again comment on the issue and call upon the Department of Health to reverse its previous decision and abandon the notion of a SEP.

2. The effect of price controls

The most fundamental problem with price controls, whether they are for medicines or for any other product, is that they interfere with the normal pricing mechanism and the signals that prices send to buyers and sellers. If consumers appear willing to buy more of a product, then manufacturers will have an incentive to produce more of that good and more manufacturers will enter the market. Because of competition for consumer demand, manufacturers are likely to research the product so as to improve it and provide greater choice for consumers. As consumer demand increases, we expect supply to increase as the dynamic market adjusts to satisfy the demand. The determination of market prices through continual changes in demand and supply is therefore the basic building block of economics.

Price controls distort that pricing mechanism and interrupt the dynamic demand and supply process. Consumer tastes and needs change continuously and as demand for a particular product rises or falls, so the price rises and falls, sending signals to manufacturers to adjust the supply of the product in a never-ending trend towards an equilibrium price. Government-set prices are usually arrived at after a negotiated political process, but once set, that fixed price cannot adjust to account for the ongoing changes in demand for the product. If a price is set too high by government, the supply of that product will exceed demand. For instance, European governments set the price of many agricultural products above the price that would be achieved through a normal market process. This means that European farmers produce far too much milk, maize and pork to the detriment of consumers in their role as taxpayers.

If government sets the price of a good below the equilibrium price level, consumers are signalled to consume more of the product than manufacturers would normally produce at that price. With increased demand and without any incentive to increase supply, shortages arise which in turn reduce consumer choice and lead to welfare losses. Because not enough of the good is sold, a deadweight loss arises because income is lost to the producer and the consumer is left without the good he or she desires.

3. Implications for micro retailers and poor consumers

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. Price controls tend to penalise the low volume establishments that serve the poor, therefore forcing them to travel to urban centres, incurring costs and inconvenience in order to shop. Price controls are essentially patronising as they assume that poor consumers (on whose behalf the controls are devised) are unable or too ignorant to make valid choices for themselves.

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 retailer can still remain in business, no other kind of business will be able to compete. Not only does this harm emerging businesses, but it also reduces consumer choice and therefore welfare.

The effect of the imposition of the SEP on South Africa's pharmacies is as predicted. Large pharmacies have benefited, small pharmacies have suffered and patients have lost convenience and the advice of a known and trusted pharmacist. Patients purchasing from the local corner pharmacy were fully aware that they were paying more for convenience and advice. The regulations have now in many cases deprived them of the right to choose that option. It is not a legitimate function of government to reduce the options of its citizens in this manner.

4. Price controls always have negative consequences

By interfering in the normal market process, price controls discourage normal price competition and stifle innovation, research and development. Without any normal price signals, manufacturers cannot respond to the needs of consumers and are therefore often unwilling or unable to improve their product and to compete effectively in order to meet the needs of consumers.

It may be argued that healthcare and medicines are somehow different to other goods and that therefore price controls are justified. The market for medicines and healthcare however are subject to the same laws of economics as any other good or service. In fact, given the importance of good healthcare for human well-being and the highly damaging effects of price controls it is imperative that price controls are NOT imposed on medicines. Indeed, food is more important for human survival and welfare than medicines and the government quite correctly removed the many price controls on agricultural products precisely because of the damaging effects on the economy and on consumers. For many centuries governments around the world have tried to impose price restrictions on food and this has almost always led to reduced supply of food and ultimately famine. The price controls on medicines will have exactly the same impact and in the long run will harm patients and increase the suffering of some of the most vulnerable and needy South Africans

The evidence suggests that drug price regulations, even in wealthy economies such as Canada and Japan, delay the registration of new drugs. Manufacturers have greater incentives to register their medicines and comply with the increasingly onerous regulatory requirements in countries where they have greater freedom to price their products without bureaucratic intervention. The registration process in South Africa already delays the registration of drugs, imposing considerable costs on drug companies. The drug price regulations are likely to increase the delays of drug registration and/or stop manufacturers from registering the drugs at all. The healthcare outcomes are likely to be severe and will reduce patient welfare as well as the ability of physicians to care for their patients.

5. Reduced drug access

Apart from the delays in registering drugs and the reduced overall availability of innovative new medicines, the drug price regulations will force many more pharmacies and wholesalers into bankruptcy on closure and ensure that the distribution of drugs to rural and remote areas will be financially unviable. The intended regulations will reduce the income stream and profit margins for pharmacies, wholesalers and distributors to such an extent that it will become impossible to carry a wide range of medicines. Many of these companies will be forced to diversify their businesses by selling cosmetics and other products and reduce their involvement in healthcare products. The lack of profitability in the sale and distribution of medicines will also reduce the incentive for pharmacists to invest in training and skills development, which in turn will harm many patients who seek advice directly from pharmacists.

In rural areas or townships that are not well served with large high volume retailers and pharmacies, poor consumers and patients choose to 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 is to travel long distances (thereby incurring travel costs) to access medicines from the high volume, low mark-up retailers in urban centres. The regulations are doing considerable harm to consumers by undermining their choices as they drive the convenient (but low volume, high mark-up) retailers out of the over-the-counter medicine business.

6. Shortages of drugs, parallel trade and theft

Drug price regulations distort the normal market clearing process and effectively increase demand for medicines without providing the economic incentives that serve to match demand with supply. As demand outstrips supply the resulting shortages in drugs will reduce the ability of healthcare professionals to provide high quality care to their patients and will therefore reduce patient welfare. Apart from these shortages, the regulations provide incentives for parallel trade in medicines (selling low priced South African medicine to countries that have higher prices) and will encourage theft of medicines. All of these will greatly reduce patient welfare.

7. 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 will have already reduced incentives to conduct trials and invest in scientific infrastructure and knowledge as the ability to make appropriate returns on the investment have been reduced.

8. Reduced manufacturing in South Africa

There has been an increasing trend among the research based drug companies to concentrate manufacturing in various centres of excellence around the world. Because of this and to some extent as a result of mergers, since 1994, approximately 35 drug companies have ceased to produce their products in South Africa. This has not only cost the country jobs, but has reduced the scientific skills and knowledge base in the country and has hampered attempts to increase technology transfer. The drug price regulations simply exacerbate this trend and more and more companies will cease production, imposing significant economic costs on the country.

9. Regulations will become increasingly complex and onerous

The drug price regulations are likely to become ever more complex and onerous to comply with. During the Nixon administration, price controls began with 3.5 pages of regulations but before long they grew to over 1,500 pages. Regulation cannot emulate all the various factors affecting supply and demand that are normally captured in a free market pricing system. This leads to ever more complex and onerous regulations as the regulators try to carry out the functions of the market. In addition to this, the fact that the bureaucracy will have significant powers over the commercial decisions of private companies will generate a great deal of rent-seeking behaviour from vested interests. This generally reduces choice for consumers and harms patient welfare.

10. Fewer Empowerment Opportunities

Price controls tend to favour the large incumbent industries that have large sunk-costs and economies of scale. Prices tend to be set at levels that keep the high volume, low mark-up businesses operating, albeit at lower profits. However, the regulations also protect these industries by making it virtually impossible for any other new competitors that would have higher margins, lower volumes and no economies of scale, from entering the market. Not only does this harm consumer choice, but also it reduces the opportunities available to new entrants. As these regulations will protect the large incumbent industries they would seem to be directly at odds with the government's stated policies of increasing opportunities for black pharmacists especially those who wish to open pharmacies in low-income communities.

11. Reduced price competition

As explained above, it is not necessarily true that countries that do not have drug price regulations have higher prices. While drug prices in the US are higher for some drugs, they are lower for others and the fact that there are few price regulations means that there is very active competition among generic drug producers. The fact remains that competition is a far more effective way of protecting consumers than price controls. The price regulations may end up reducing price competition among manufacturers and in the long run harming the consumer by fixing prices above what would otherwise have been achieved in an open competitive market.

12. Conclusion

Despite the best intentions of the South African government to make drug prices as transparent as possible, the pricing regulations merely frustrate the efficient functioning of the market. Most notably the drug price controls reduce access to medicines, reduce the incentives to invest in research and development and frustrate competition. South Africa's patients, including low-income patients are harmed by the SEP. The public sector has had the benefit of extremely low prices for the medicines destined for the care of the poorest members of the population. These low prices have to a large extent been made possible by the profits earned by manufacturers and importers from the more affluent citizens of the country. Cutting down the profits that can be earned by the manufacturers in the private sector of the economy decreases their ability to cross-subsidise the public sector. The consequences must eventually be that the taxpayer-funded public sector will have to pay higher prices for medicines. There are very few winners from the imposition of a Single Exit Price for medicines and we would therefore urge the department of Health to repeal the regulation establishing the SEP and revert to prices established in a competitive market for medicines.

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