



Negotiating Pharmaceutical Prices: A Change in Chinese Health Policy



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Abstract

Like many other nations, China believed the key to restricting national health expenditures for pharmaceuticals was the use of governmentally imposed price caps. Given the recent growth in pharmaceutical expenditures, China is moving away from price caps to a new process that includes locally negotiated prices in the hope that such price competition will lower national pharmaceutical pricing. The success of this policy endeavour will depend significantly on managing other aspects of pharmaceutical purchasing.

China's recently announced decision to lift central government-imposed price caps on pharmaceuticals is an interesting development in the nation's health policy. Under the newly announced measures, as one part of national health reform efforts, pricing power regulation for Chinese purchases of pharmaceuticals would shift to many local government entities. Pharmaceutical manufacturers will have to go through provincial bidding processes in order to win contracts with hospitals and insurance companies (Burkitt 2015).

The policy change undoubtedly reflects the central government's concern with rapidly increasing pharmaceutical costs. From 2013 to 2014, pharmaceutical sales increased by 14% from \$92,100,000,000 to \$105,000,000,000. Any effort to restrain national healthcare expenditures would have to take into consideration the impact of pharmaceuticals on total spending. China's spending on pharmaceuticals is about 40% of the total national healthcare expenditures compared to the international norm of 15% to 25% (Thomas 2015).

Market Pricing Dynamics

Price caps on pharmaceuticals have traditionally been viewed as a means to reduce drug expenditures in the short run. Many nations believed that such centrally imposed restrictions on drug prices would lead to a reduction in drug expenditures, as part of national efforts to reduce total healthcare expenditures. Assuming that the capped prices were below the previous pricing levels and that purchased quantities did not increase, the anticipated result would be lowered total expenditures. In imposing such price caps, China's Central Government obviously believed that this would help control pharmaceutical expenditures.

A major argument against pharmaceutical price controls is the belief that such measures will negatively impact the research and development expenditures, which drug companies must make in order to produce new medications for the future (Feldstein 2011). Limitations on pharmaceutical prices are believed to limit manufacturer's margins, thereby reducing the incentive to invest significantly in the development of new products for the future. While reduced pricing resulting from price caps may theoretically benefit purchasers in the short term, the belief is that they would have negative long-term impacts on the pharmaceutical industry.

Price controls only have their desired effect on pharmaceutical drug expenditures if the quantities of pharmaceuticals prescribed under the price controls are held within certain limits. That is, a reduction in the unit price of the pharmaceuticals will be easily off-set or exceeded if the quantities of pharmaceuticals ordered under these price controls exceed the quantities ordered prior to the price controls being put into effect.

In many of the world's nations, the effort to reduce the quantity of medications required can prove problematic. Factors such as the aging of national populations and the incidence of disease, as well as population growth, mean that pharmaceutical utilization would be expected to increase in the absence of appropriate policy measures.

Price controls of any sort have always remained somewhat controversial in the eyes of many economists. Issues associated with price controls on pharmaceuticals have been summarized by Scherer (2000) as follows:

"In sum, efforts by national authorities to curb pharmaceutical costs and offset the demand increasing effects of generous health insurance by imposing drug price controls are found throughout the industrialized and less-developed world. These sometimes succeed in their proximate goal, but cause bulges in other parts of the health care balloon, bias new drug research and development incentives, and distort international trade and investment patterns. Although one may share the underlying cost control goals, a review of the consequences suggest that the aversion of most economists to price controls is well founded."

In China, the hope would be that locally negotiated prices would be less than, or at least equal to, prices under the national price control mechanism. A reasonable assumption under such a mechanism is that the newly

negotiated local prices would be somewhat similar on a region-by-region basis.

A chief concern of Chinese policymakers will be the likely impact that such a new pricing mechanism has on domestic pharmaceutical companies. Will the newly negotiated prices encourage market expansion in further development of manufacturing and research capabilities by Chinese drug manufacturers?

As the world's second largest economy with a population of more than 1.3 billion people, China's new policy on prescription drug pricing will be closely watched in many other nations to see what impact it has on total pharmaceutical and healthcare expenditures.

Some Other Considerations

China experimented with lifting centralized price controls once before, in the period from 1992 to 1996 (Sun et al. 2008). That experiment came to an end in 1997 over government concerns of price increases resulting from market-based pricing, poor quality control of pharmaceuticals offered within the country and corruption and kickbacks. It would appear that the current situation merits a reconsideration of price cap elimination.

The magnitude of pharmaceutical expenditures as a percentage of China's national healthcare expenditures would seem to be a major consideration in the recent policy change. In China, pharmaceutical expenditures constitute 40% of the total national health expenditures as compared to 16% in Organisation for Economic Co-Operation and Development (OECD) countries (The Economist 2014). By 2016, China is expected to become the world's second largest pharmaceutical market (ibid). This growth is predicated upon predictions of an aging population, the expansion of public health insurance which pays for pharmaceuticals, and the demands of a wealthier society.

Pharmaceutical sales have also contributed significantly to the funding of China's public hospitals. Government subsidies contributed approximately 9% of hospital revenues as of 2011, while the sale of medicines accounted for an additional 40% (ibid). Although efforts are underway to curtail certain markups, the current policy allows Chinese hospitals to markup pharmaceuticals by a 15% margin prior to sale to the public. The enhanced revenue from pharmaceutical sales by hospitals also benefits physicians, many of whom work in these public facilities.

Since hospital and physician income are dependent on pharmaceutical revenues, there is little incentive on the provider side to reduce either the price or utilization of prescription drugs. In fact, recent prosecutions have focused on inflated drug invoices, used as a means of increasing revenues to hospitals. According to Sun et al (2008):

“Contradictory goals plague China's pharmaceutical policy. The government wants to develop the domestic pharmaceutical industry and has used drug pricing to cross-subsidized public hospitals. Yet the government also aims to control drug spending through price caps and profit margin regulations to guarantee access even for poor patients. The resulting system has distorted market incentives, increased consumers' costs, and financially rewarded inappropriate prescribing, thus undermining public health.”

Considerations for The Future

If China's most recent effort at lifting nationwide drug price caps is to be successful in restraining pharmaceutical expenditures, the national health policy should be rethought to take into consideration certain concepts that could conceivably lead to successful policy implementation.

1. All efforts should be made for Chinese healthcare providers to make use of effectiveness studies on various pharmaceutical agents before approval of purchase. Such effectiveness studies are becoming an increasingly important part of health economic policy throughout the world. As Taylor (2004) indicated: "Increasingly, new drugs must show evidence of cost effectiveness." The introduction of effectiveness studies, and their use in pharmaceutical purchasing decisions, can demonstrate the value of certain pharmaceutical purchases compared with others.
2. Negotiated pharmaceutical prices, as evidenced through local and regional purchases, should be transparent nationwide. That is, the prices negotiated by local authorities in one region should be made available for informational purposes to purchasing officials in other areas. Such information diffusion would hopefully lead to comparable pricing, and constitute an important source of market information. Any perceived deviations from such pricing norms should be thoroughly justified in order to rationalize price disparity.
3. Despite the factors listed above indicating potential reasons for the increased use of pharmaceuticals in China in the future, serious efforts must be taken to reduce and/or limit the quantities of pharmaceuticals purchased as reflected in national health expenditures. Newly negotiated prices may be effective to a certain degree, but if there is no check on the quantities of pharmaceuticals ordered, overall drug expenditures will not be reduced.

The success of the new Chinese drug pricing policy will, in a large part, be determined by successfully addressing some major internal considerations. Economic theory would indicate that negotiated prices do have the opportunity to reduce healthcare expenditures, but the ultimate success of the endeavour will be determined by addressing other significant internal national concerns such as the overall quantity of pharmaceuticals utilized. Among the external concerns to be addressed are the overall international price levels and the willingness of pharmaceutical manufacturers to meet the price expectations of local negotiators.

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