

# *The Medicare Innovation Subsidy*

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Lowering prescription drug costs is a policy priority across the political spectrum. The pharmaceutical industry has consistently responded that such proposals would slash incentives to develop new drugs. Industry advocates are right that reducing reimbursement rates will reduce the returns for developing new drugs, and thus may negatively impact innovation. But we think it is misleading to suggest that current profits simply reflect the “market value” of a drug.

It isn't news that pharmaceutical patents allow above-cost pricing. That's their point. In the U.S. pharmaceutical market, however, innovating firms today often receive profits above the monopoly level. Rather than receiving merely a market return of the monopoly price times the quantity of patients who would purchase the drug at that price, a firm can receive the monopoly price times a much higher quantity of patients who receive the drug through insurance. That is compounded by the fact that the government mostly can't negotiate prices with drug companies. Expanding the ability of patients to pay while not negotiating prices changes the demand curve for drugs, creating a greater-than-monopoly reward for pharmaceutical patents. And we have seen just that effect in the wake of Medicare Part D.

Patent policy and Medicare reimbursement combine to give an above-monopoly return, not as a matter of deliberate policy but because the two sides are setting innovation policy without thinking about how they interact. We might be over-rewarding pharmaceutical innovation, or at least diverting it toward innovations reimbursed by Medicare Part D. And if we aren't, that's because the preexisting combination of patent protection and regulatory exclusivity was insufficient for those drugs. Policy discussions about health care today are primarily focused on access without considering incentives, but we should focus on both. We are in fact making innovation policy when we decide what to cover and the terms under which it will be covered, but because we're framing it in terms of access, the innovation impacts are waved away. "