Medicare Reimbursement for Prescription Drugs: An Overlooked Policy Lever for Innovation

Author : Jessica Lind Mantel

Date : March 11, 2020

Mark A. Lemley, Lisa Larrimore Ouellette, and Rachel Sachs, *The Medicare Innovation Subsidy*, N.Y.U. L. Rev. (forthcoming 2020), available at SSRN.

Over the past few decades, policymakers have used Medicare reimbursement policy to achieve wide-ranging changes in the health care system. Recent efforts have focused on using the levers of Medicare payments to encourage innovation in providers' organizational structures and health care delivery. In their forthcoming article *The Medicare Innovation Subsidy*, Lemley, Ouellette, and Sachs consider another type of innovation influenced by Medicare reimbursement – innovation in the pharmaceutical market.

Both the Trump Administration and members of Congress have put forth various proposals to address high prescription drug costs in the Medicare program. In addition, some Democrats have advanced health reform proposals that would broaden insurance coverage for prescription drugs and lower patients' out-of-pocket drug spending. While debates over these proposals have largely focused on the policy goals of lowering prescription drug costs and increasing access, Lemley et al. argue that attention also should be given to how these proposals impact incentives for developing new drugs. Specifically, the authors argue that health insurance coverage changes market demand for prescription drugs, thereby impacting drug manufacturers' profits and their financial incentives to innovate.

The U.S. has a long history of encouraging drug innovation through the patent system. Patent owners enjoy various legal rights that allow them to charge higher prices than they otherwise would garner in a competitive market with generic competitors. Accordingly, conventional wisdom predicts that drug policies lowering reimbursement rates below the supracompetitive prices patent holders could otherwise charge would reduce the returns for developing new drugs, thereby negatively impacting innovation. Indeed, one frequently hears this argument from the pharmaceutical industry. The authors, however, argue that this story is incomplete, as it overlooks how public subsidies funneled through the Medicare program increase incentives to innovate by expanding pharmaceutical companies' profits.

After providing an overview of drug coverage under Medicare and other government programs in Part I of the article, Part II explains how Medicare increases innovation incentives for the pharmaceutical industry. As compared to a market without insurance, insurance coverage for prescription drugs shifts the demand curve for drugs by lowering consumers' out-of-pocket costs. For example, a consumer with a 20 percent coinsurance obligation who is willing to pay $100 out-of-pocket for a drug can buy a $500 drug, as their insurer will cover the $400 difference. This increased demand not only leads to a larger volume of drugs sold, but also permits the monopolist-patent holder to charge a higher price to the insured consumers who can now pay more for their drugs. Consequently, adding a prescription drug benefit to Medicare (known as Part D) increased pharmaceutical companies' profits through both higher volume and higher prices, with the additional profits creating incentives for further drug development. A number of empirical studies cited by the authors support this story, finding increases in private-sector investment in research and development (R&D) following implementation of Medicare Part D, especially for those drugs with higher Medicare market share. The authors refer to this as the Medicare innovation subsidy.

In Parts II.C and III, the authors discuss how recognition of the Medicare innovation subsidy changes the policy discussion about prescription drugs. For example, to the extent Medicare expansion would give more Americans access to generous drug benefits, policymakers wishing to keep overall innovation incentives unchanged can offset the increased Medicare innovation subsidy with reduced drug prices. Alternatively, policymakers can cut other innovation

incentives, such as making patent laws less favorable to patent holders or lowering R&D tax incentives. Policymakers also should be mindful of the innovation asymmetries caused by Medicare and Medicaid reimbursement policies that make certain types of drugs more profitable than others. For example, Medicare rules that require Part D plans to cover all FDA-approved drugs within six protected drug classes has resulted in higher prices, and thus higher profits, for these drugs. The higher profits in turn have spurred a larger increase in new R&D for drugs in the protected classes relative to other drugs. Similarly, Medicaid cost-containment policies that lower Medicaid drug prices relative to Medicare drug prices can bias new R&D in favor of drugs that primarily benefit the elderly.

More broadly, in highlighting the interplay between patent law and Medicare policy, the article reminds us that Medicare policy does not exist in a vacuum; rather, policymakers should be mindful of Medicare's far-reaching impact and its potential to change incentives throughout the health care system.

Cite as: Jessica Lind Mantel, *Medicare Reimbursement for Prescription Drugs: An Overlooked Policy Lever for Innovation*, JOTWELL (March 11, 2020) (reviewing Mark A. Lemley, Lisa Larrimore Ouellette, and Rachel Sachs, *The Medicare Innovation Subsidy*, N.Y.U. L. Rev. (forthcoming 2020), available at SSRN), https://health.jotwell.com/medicare-reimbursement-for-prescription-drugs-an-overlooked-policy-lever-for-innovation/.