

**REFORMING MEDICARE**

**Option: Require Drug Companies to Give Rebates or Discounts to Medicare**

**Under current law, drug manufacturers are required to give rebates or discounts to the Medicaid program for prescription drugs purchased by Medicaid beneficiaries. However, Medicare Part D — the optional prescription drug coverage — does not require similar manufacturer rebates or discounts. This proposal would require manufacturers to provide Medicare with the same rebates or discounts as those Medicaid receives for drugs purchased by certain low-income Part D enrollees.**

*Argument for:*

**Henry J. Aaron, Ph.D.**  
The Brookings Institution

*Argument against:*

**Stuart Butler, Ph.D.**  
The Heritage Foundation

**Henry Aaron**

The Medicare Modernization Act (MMA), which took effect in 2006, provided an unintentional multibillion-dollar windfall for drug companies at the expense of the American taxpayer

Here is how it happened. Before 2006, between 15 and 20 percent of Medicare enrollees received drug coverage under Medicaid (a different government program) because they are poor or disabled. Under federal rules, drug companies are required to give Medicaid sizable discounts below the price charged to others. (The Veterans Administration demands—and gets—similar discounts.) The MMA transferred those Medicare enrollees also covered by Medicaid—the so-called “dual eligibles”—to the new drug benefit for Medicare enrollees, Part D. But Part D is administered by private companies, rather than the government. These companies, in many cases, lacked the power to negotiate discounts as large as Medicaid received—or, for some drugs, much discount at all. As a result, the price of drugs for Medicare enrollees is higher than that under Medicaid and other government programs.

The cost is large. Dual eligibles are much heavier users of drugs than is the average Medicare enrollee, and they are particularly heavy users of some expensive drugs. As a result, they account for well over half of all spending under Medicare Part D. If drug companies were required to give the same discounts for drugs for dual eligibles and other low-income beneficiaries as they now provide for Medicaid enrollees, Medicare spending would be cut \$112 billion over the next decade. These savings would spare the nation the need to raise taxes or cut other spending by similar amounts. That is why many groups

## Medicare Reform Option: Require Drug Companies to Give Rebates or Discounts to Medicare

that have proposed ways to cut the overall deficit and Medicare spending have endorsed this change.

Nothing comes for free, however. Drug companies indisputably use the expectation of profits to guide research to find new drugs. Experts believe that the impact of restoring the discounts on drug sales for dual eligibles may somewhat discourage research. But not all new drugs are better than old ones. And drug companies are now spending more on marketing than research. If spending has to be cut somewhere—and it does—this is a good place to begin.

### Stuart Butler

Some people think that requiring drug companies to reduce the prices they charge Medicare for low-income older people with Part D drug coverage would reduce Part D costs and be a good idea. It would not be—prices would just go up for other Americans, and there would be less research on cures for diseases like Alzheimer's.

One reason it is a bad idea is that making drug firms cut their prices in one place just means they will tend to raise them somewhere else, just as squeezing one end of a balloon causes it to expand somewhere else. That's why it turns out that when your bank is told to end a fee on one service, it just raises the fee on another service. So requiring a reduction—known as a “rebate”—on the cost of drugs for some or all older people in Medicare Part D just means someone else will pay more, such as working Americans who have to fill prescriptions for themselves or their children.

But let's say the drug firms that were forced to give rebates in Medicare were somehow not able to recover the lost revenue from higher charges on other Americans. That would mean the total revenue they obtained from those drugs widely used by older people would fall. That might seem to be no problem for Medicare beneficiaries—just a problem for the companies and their investors. But there's more to it. Knowing they would have to give the Medicare program rebates on future new drugs would make it less attractive for these firms to make the heavy and risky investments needed to find better drugs for diseases primarily afflicting older people, such as Alzheimer's. That would be bad news for both today's and tomorrow's older Americans. The bigger the forced rebate, the greater the disincentive to invest in breakthrough drugs aimed at older people.

In addition, requiring a rebate would get in the way of existing negotiations over drug prices between the competing plans that offer Part D drug coverage and the drug companies. The tough competition and smart bargaining strategies they have used have enabled the Part D program to provide coverage at less total cost to Medicare than was expected. That's why premiums in Part D have been lower than many expected. Having today's negotiating flexibility leads to fewer of the bad side effects that I just described from government-required rebates. Part D is one of the areas of Medicare that actually works quite well.

That is not to say nothing is needed. Like other parts of Medicare, the revenue from Part D premiums covers only a small part of the actual cost. So today's and tomorrow's taxpayers will have to write bigger and bigger checks to the Internal Revenue Service if no action is taken. So while some very high-income seniors do pay a bigger proportion of their Part D cost today, it is reasonable to ask better-off seniors to pay more or even all of the cost of Part D.

**Henry J. Aaron, Ph.D.**, is a Senior Fellow in Economic Studies and The Bruce and Virginia MacLaury Chair at The Brookings Institution.

**Stuart Butler, Ph.D.**, is a Distinguished Fellow and Director of the Heritage Foundation's Center for Policy Innovation.

Perspectives 11, June, 2012

AARP Public Policy Institute,  
601 E Street, NW, Washington, DC 20049

[www.aarp.org/ppi](http://www.aarp.org/ppi)

202-434-3890, [ppi@aarp.org](mailto:ppi@aarp.org)

© 2012, AARP.

Reprinting with permission only.

The views expressed herein are for information, debate and discussion,  
and do not necessarily represent official policies of AARP.