

The barriers of entry and exit economics essay

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Within my literature review, I will discuss and evaluate the main pieces of literature that I will use when composing my dissertation. I have analysed the various pieces of work in the order of my proposed structure (in themes) to ensure a broad spectrum of reading and total coverage of the main points within my dissertation. However, these are not the only literatures that will be used, in the forms of news articles, journals, books and official publications.

Barriers of entry/exit

The number of substitutes available for a certain product can act as a barrier to entry. In the case of the pharmaceutical industry, the relevant substitutes to a brand name are in the form of generic products/drugs. Whilst reviewing various literatures, it is evident that there has been much debate over what effect generic products have on the competitiveness of the pharmaceutical industry. Frank and Salkever (1997) state that when generic products enter the market against branded names, the prices of the branded names increase whilst the prices of the generic products decrease. They created a model to justify the results consisting of two groups of consumers, a quality-conscious group which continues to buy the branded product even when generic products enter the market, and a price-conscious group which buys from the generic product (Frank and Salkever, 1997). Therefore, as generic products enter the market, the demand for branded products will decrease and become less elastic, hence the increase in price (Frank and Salkever, 1997). This idea is counteracted by Wiggins and Maness (2004) which illustrate that the entry of generic goods will increase competition within the industry and drive both generic and branded prices lower. Therefore Wiggins

and Maness (2004) suggest that the market is less segmented with different types of consumers than what Frank and Salkever (1997) initially proposed. Wiggins and Maness (2004) conducted empirical evidence to show that when the number of sellers in the industry increased from 1 to between 6-15, the prices of branded products reduced by about 83%. This heavily contrasts to the results found by Frank and Salkever (1997) which conducts similar empirical analysis and shows that there was about a " 50% increase in the price of branded products around 5 years after generic entry" (Frank and Salkever, 1997, pp. 83), a " 40%-50% shift in market share from brand-name products to generic products and a 25%-30% reduction in generic goods prices" (Frank and Salkever, 1997, pp. 89). This consolidates the fact that Frank and Salkever (1997) provide evidence which goes against traditional concepts of competition. However, there are some limitations associated with both literatures discussed. With regards to Frank and Salkever (1997), the paper studies a sample of 32 drugs whereas Wiggins and Maness (2004) acquires data from a much wider spread of drugs (anti-infectives) therefore one could argue that Wiggins and Maness' (2004) results are more credible based on the size of the sample they have used. Both the literatures are using empirical analysis which is relatively backdated and so the results are most likely inaccurate for today's pharmaceutical industry. Frank and Salkever (1997) are using drug data from the period 1979-1987 and Wiggins and Maness (2004) used drug data of anti-infectives from the period 1984-1990. Therefore, this needs to be considered and noted when composing the argument within my dissertation. Another form of a barrier to entry is the patent system that is extremely significant in the pharmaceutical industry. Lehman (2003) is a document used to introduce the idea of a patent and to <https://assignbuster.com/the-barriers-of-entry-and-exit-economics-essay/>

emphasise the importance of issuing patents in order to encourage innovation within the pharmaceutical industry. The literature discusses how patents work differently in certain industries with the pharmaceutical industry being the most unique. Special problems that are applicable to the pharmaceutical industry include smaller periods of patent exclusivity due to the extensive research and development and testing required before being sold on the market, and the ease and low cost replication of patented products. The literature also discusses in-depth about how patents are indirectly contributing to inequality by using the following argument. Developing countries lack commercial pharmaceutical industries due to the small amount of patents being issued from them. " 95% of all patent filings are nationals of OECD countries" (Lehman, 2003, pp. 9). This then results into excess investment within the U. S. The U. S. have also adopted a strong patent scheme and flexible price systems; adding to the attractiveness of the country. This has resulted in the " US, EU and Japan accounting for 80% of market share whilst Africa, Asia, Latin America and the Middle East represent only 20% of the market combined" (Lehman, 2003, pp. 12). This particular paper also argues that issuing a patent may encourage generic products being produced as the patent does not forbid the development of a generic drug but just the selling of the drug within the market. This point may be linked back to the conflicting argument presented regarding substitutes of a product. Although this paper discusses the patent system as a whole, including the speciality within the pharmaceutical industry and the problems surrounding the idea, it does not explicitly demonstrate how the patent will act as a barrier to entry for other firms. This is better explained within Possajennikov (2010) which focuses on the theoretical side of patents <https://assignbuster.com/the-barriers-of-entry-and-exit-economics-essay/>

and how it can restrict the entry of other firms. The idea discussed is based upon patents aligning social benefits with social costs and how a monopoly will be formed once the patent has been issued as it immediately destroys all competition from the particular idea/product that is being protected. This ensures that the inventor gains an attractive return for their product. Therefore, when talking about patents as a form of barrier, these two literatures being used in conjunction with each other will prove to be beneficial.

Do pharmaceutical industries earn high profits due to the abuse of market power?

My analysis on whether a high profit in the pharmaceutical industry is due to abusing market power will come from a combination of data analysis and various literatures. There are many conflicting views regarding the reasons behind such high profits, which are going to be highlighted. Roberts (1999) discovered that once high profits have been attained, the persistence of profits could be due to either the anti-competitive explanation (which most industrial economists adopt) or the innovation explanation. The latter is also supported by Montgomery, 1995. (Roberts, 1999) Using econometric analysis, Roberts (1999, pp. 666) states the following results: long-run profit falls from 0.4 to roughly 0.8 as the firm moves from the upper to the lower end of the innovative propensity variable. Considering only the high profit observations, the long run rate falls from 0.73 to -0.22..... However, the analysis provides very weak support for the anti-competition thesis as the coefficients on the low competition variables were insignificant in both regression models (1999, pp. 666) Therefore Roberts (1999) does not only

provide results supporting the idea that the higher the amount of innovation, the more persistent the profits but also finds that persistent profits in the pharmaceutical industry can be explained by high innovative propensity rather than the firm avoiding competition. The data within Roberts (1999) is based on the U. S pharmaceutical industry which poses a restriction as the results are not a reflection of the U. K pharmaceutical industry. However, these results may be useful to study the industry as a whole rather than by region. The analysis also focuses on one type of innovation, product innovation; therefore the term "innovation" needs to be explicitly defined within my dissertation to ensure accuracy in analysis. The results within Roberts (1999) are consistent to the theory presented by Mueller (1990) as he also discusses that the reason behind long-term profitability is due to constant innovation (Roberts, 1999). Schumpeter (1934) also argues that innovation creates a monopoly which generates high profits and these will create imitators, consequently driving profits back to its normal level (competitive market forces) and this process then repeats i. e. there are persistent profits. Another view discovered is based on the efficiency hypothesis. Demsetz (1973) argues that if larger firms are earning higher profits then it is due to not only the industry structure but a combination of a further two aspects; luck and they may be more competent in meeting consumer requirements than those earning lower profits, i. e. they are more efficient in the way that they operate. This obtains the same result as an industry with high concentration; short term monopoly power. These views contrast to those that are adopted by general industrial economists that believe that competitive market forces should drive down profits to normal levels (Roberts, 1999). Even though the above literatures discussed is <https://assignbuster.com/the-barriers-of-entry-and-exit-economics-essay/>

available to create an argument against high profits being the result of abusing market power, I will have to relate it back to the empirical evidence of which I have acquired to ensure that the argument is strong enough and applicable to the pharmaceutical industry because it may be the case that the data I have put together indicates abuse of market power i. e. making the above argument weaker.

Does competition inhibit or create innovation?

For my discussion around competition and innovation within the pharmaceutical industry, one literature which discusses this argument in great detail is by OECD Competition Commission (2006). The document discusses the two opposing theories that have been adopted about the relationship between competition and innovation. The Schumpeterian theory refers to the idea that dominant firms are more likely to innovate than those who have less market power as it is easier to recover costs and earn profits, whilst the counteracting theory states that the more competition there is in the industry, the more likely it is for innovation to occur due to the incentive to get ahead of the game (OECD Competition Commission, 2006). The paper does not carry out new research and findings but instead, discusses results and conclusions which have been discovered by other scholars. The assumption is that studies discussed, almost always use the assumption that concentration ratios or market shares are a reflection of competition and R&D intensity or the number of patents granted is a reflection of innovation (OECD Competition Commission, 2006). The main finding is that concentration and R&D intensity have a positive correlation at low levels of concentration with R&D activity reaching a peak (at C4 of about 50%-60%

and maximised at 52% according to Levin et al, 1985) with the relationship becoming negative at higher levels of concentration (OECD Competition Commission, 2006). Mahmood and Lee (2004) justify this relationship by arguing that barriers to entry are the cause of the inverted U-shape relationship. Carlin et al, (2004) explain the inverted U-shape with a different approach by incorporating an " unexpected, external event which causes a change in the level of competition in a given market" (OECD Competition Commission, 2006, pp. 48) Thus they examined firm performance after the privatisation of state-owned enterprises in 24 countries and their results stated that some competition is required in order to stimulate innovation (OECD Competition Commission, 2006). However, the main limitations involved with this literature are that it does not discuss alternative incentives to innovate such as the " degree of technological opportunities present in the industry, regulatory controls or new tax laws" (OECD Competition Commission, 2006, pp. 17). However, the relationship does not hold when including technological opportunity as it reduces the significance that concentration variables have in the regression analysis; concluding that once more factors are included, market power is not so significant in influencing levels of innovation. (OECD Competition Commission, 2006) Therefore, more competition does not necessarily create more innovation when accounting for technological opportunity. In conclusion, although the text is beneficial for suggested theories and past empirical evidence on the relationship as a whole, it also provides ambiguous empirical results and does not discuss the relationship experienced in the pharmaceutical industry in particular and therefore more research is required in order to find a concrete conclusion via primary research. Word count: 1988