ABSTRACT: On the Role of Parallel Trade on Manufacturers and Retailers Profits in the Pharmaceutical Sector

Differences in regulated pharmaceutical prices within the European Economic Area lead can be exploited by pharmacy retailers using parallel imports. Such strategic decisions can affect the sharing of profits in markets for prescription drugs, including the profitability of innovating pharmaceutical companies before patent expiry, when parallel trade is the unique source of upstream competition. We develop a structural model where retailers can alter the set of goods which the consumer can choose from, in response to differences in profitability across products. Our demand model with unobserved choice sets can be identified using supply side conditions for optimal choice sets decisions in addition to individual consumers' choices. Estimating our model with rich data on a pharmaceutical market featuring parallel imports, we find that retailer incentives play a significant role in fostering parallel trade penetration. Our counterfactual simulations show that the parallel imports of drugs has large implications for the distribution of industry profits. In particular, retailers gain at the expense of pharmaceutical companies, while parallel traders only attain modest profits. Finally, a policy preventing pharmacies to foreclose the direct imports is shown to shift partially profits from intermediaries (pharmacists and parallel traders) to producers.