IPI Insights

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Drug Company Profits: Problem or Solution?

Merrill Matthews Jr., Ph.D.

There have been many complaints about prescription drug prices lately. Critics seem to think drugs cost too much, and they point to drug company profits as proof. The conventional wisdom — reflected by reporters who were doing stories on the presidential candidates' proposed Medicare prescription drug benefit — is that the pharmaceutical industry is the most profitable industry in the country. The implication is that drug companies make a lot of money, so what's the harm if the federal government dips into their pockets by forcing them to charge a little less?

INSIDE: Charting The Road Map for Tax Reform

ALSO: Unlocking The Privacy Issue

IPI THE NEWSLETTER OF THE INSTITUTE FOR POLICY INNOVATION

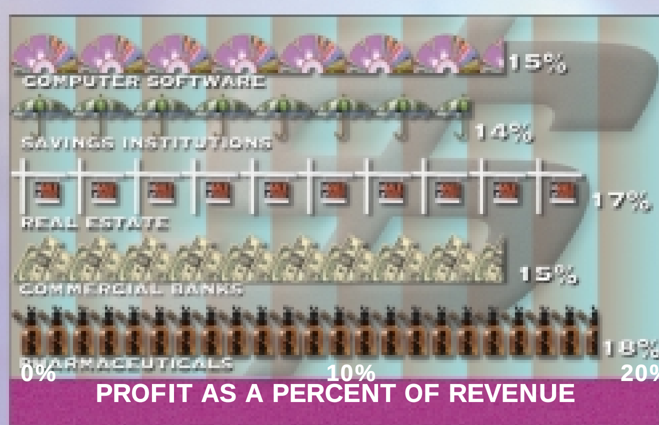
Drug Company Profits. There are really two pharmaceutical industries: one that mass-produces aspirin, cold medicines, ointments and other over-the-counter drugs. The other pharmaceutical industry — the "pharmatech" industry — is a New Economy industry, where initial costs to create and test a patentable item are very high, but once achieved the reproduction costs are usually minimal.

While it is true that many prescription drug manufacturers are profitable, and several have been consistently profitable over the years, those profits are not out of line with other successful New Economy companies and industries that produce products in high demand.

According to *Fortune* magazine's annual survey of the top 1,000 companies, the drug industry's median profit — the middle point between the most and least profitable of the 12 drug companies included — was 18 percent (profit as a percent of revenue). Amgen had the highest profit at 33 percent, with American Home Products the lowest, having lost 9 percent.

Most companies ranged between 15 and 20 percent.

Median Returns for Some of the Most Profitable Industries (1999)



Source: "Fortune One Thousand Ranked Within Industries," *Fortune*, April 17, 2000

Other Profitable Companies. Profitable, to be sure. But that isn't the whole story. Many companies that spend far less on research and development make more money than even the most profitable drug companies. Nabisco, for example, reported a 36 percent profit last year, according to *Fortune*. As the figure on the back page shows, Coca-Cola, which produces a product that is competitively priced and very affordable, had higher profits than the drug industry median for most of the 1990s.

Or how about *The New York Times*, which prints so many stories about excessive drug company profits? The *Times* made 10 percent last year. Gannett, publisher of *USA Today*, made 17 percent — right up there with the drug companies.

Of course, no one is accusing *The New York Times* or Gannett of price gouging. Indeed, it's the news media that are voicing most of the criticism. Oh, and did I mention that Tribune, a media conglomerate that includes the *Chicago Tribune*, the *LA Times* and a number of broadcasting stations, made 46 percent profit, according to *Fortune*?

When CBS ran the final segment of its hit program "Survivor," it charged $600,000 for a 30-second ad. At the time, that was the highest any network had charged for a slot in prime time, up from the previous high of $319,000. This fall, however, the popular program "ER" will also command $600,000 for a 30-second ad. The networks are very clear that when they have a popular show, they charge as much as the market will bear. By contrast, one Celebrex tablet, which costs a little more than $2.00, taken daily allows people with arthritis and other chronic pain to return to their activities.

So if CBS news were doing a story on price gouging, which would most likely be the subject: drug companies or the networks?

New Economy Companies and Monopoly Profits. Software companies are important to this discussion because they, like the drug companies, are New Economy companies. That is, they too make knowledge-based products, and both spend a lot of money up front researching and developing those products.

For example, this year pharmaceutical companies will spend about $24 billion developing and testing new drugs — about 21 percent of their sales, more than any other industry and twice as much as the computer software industry. However, even though software companies spent less than drug companies on R & D, Microsoft reported a 39 percent profit last year, while BMG Software reported 28 percent.

Once a knowledge-based company produces a prototype, mass producing the product is usually very cheap. Companies charge significantly more than it costs to produce the product in order to recoup research and development outlays. And while economists understand this process well, it can be difficult to defend from a public relations standpoint when a low-income person who wants or needs the product, but can't afford its retail price, is going

Suppose it takes $500 million (the number usually cited as the average cost to develop a new drug) to develop a new pain pill. At $2 a pill — roughly $60 for a month's prescription — a drug company would have to sell 250 million pills just to recover its research costs. That works out to nearly 140,000 people taking one pill a day for five years just to break even — and that's before the pharmacy marks up the price or the manufacturer makes a profit.

Some of the new specialty drugs that target uncommon diseases and are therefore spread over relatively few people, will have to cost a lot more. Clearly, we are entering a period in which more and more drugs will be available, but some of them won't be cheap.

public with the complaint. Without the initial outlays, the product would never have been created; and without more outlays, the company won't continue to create new products. But those facts usually get lost in the discussion.

Of course, pharmaceuticals and software are not the only products facing this pricing dilemma. Novelist Stephen King can command millions of dollars in advance royalties, which explains why a publisher might charge $25 for one of his novels that only cost a dollar or two to print. Similarly, $39.95 for a movie that has just been released in video is much more than it actually costs to create a copy of the film. In both cases, companies must lay out millions of dollars up front for authors and actors, and make their return by charging much more than the marginal cost of making one more copy.

Outgoing Secretary Lawrence Summers understands the principle well. In a May speech delivered in San Francisco and entitled "The New Wealth of Nations," Summers noted that in an information-based economy, "the only incentive to produce anything is possession of temporary monopoly power — because without that power the price will be bid down to the marginal cost, and the high initial fixed costs cannot be recouped."

Yes, drugs can be expensive — in some cases, very expensive. But if the drug companies are allowed to continue their R & D unfettered, we will see more drugs that, while expensive, will make our lives better. Thus, profits are not the problem, they are the solution — ensuring that consumers have access to advanced pharmaceutical products for years to come.

It's the Demand, Stupid. Which brings up an important point: *Drug companies aren't profitable because they charge so much; they are profitable because they make products that patients and their physicians want.* While total spending on pharmaceuticals has been growing rapidly — averaging a 13.7 percent increase between 1995 and 1999 — most of that spending is due to an increased volume of sales, not higher prices. For example, while prescription drug sales grew by 18.8 percent in 1999, 14.6 percentage points of that growth was due to increased volume and new products, while only 4.2 percentage points of the increase was due to higher prices.

The Politics of Drug Prices. Nevertheless, drug company profits have become a political issue as both Democrats and Republicans look for a way to provide seniors with a prescription drug benefit. However, it is not clear that there is a prescription drug "crisis" — about 65 percent of seniors already have some type of coverage for prescription drugs — or that either of the primary plans proposed by Republicans and Democrats would work.

If politicians really want to control prescription drug prices, there is a better way to do it than by government fiat. It's called competition. But can prescription drugs, many of which are protected by a patent, act like a real market? Yes. The drug industry is already very competitive, with no drug company having more than 7.2 percent of the market. And changes in the health care system and patients' ability to access information are making the market even more competitive.

Expanding Competition True, the pharmaceutical industry will likely never be as competitive as some industries. Several factors, such as patent protection and the consumers' price insulation through health insurance, will necessarily limit the industry's ability to act like a real market. However, steps such as reforming Medical Savings Accounts that would reduce insulation from the cost of health care or eliminating the FDA's "efficacy" requirement would go a long way in making the industry more competitive. And with that competition would come more choice and lower costs. And if drugs are available and easily affordable, who cares how much money drug companies make?

Conclusion. The new Congress is committed to looking at a prescription drug benefit. However, both the Republican and Democrat plans will create new, costly programs. If Congress is convinced it must do something, it should create a catastrophic drug benefit plan that would only pay if seniors spent more than, say, $3,000 a year. Such a plan would provide a safety net rather than an entitlement, helping only those confronted with truly catastrophic expenses. IPI

Merrill Matthews Jr. is a visiting scholar with the Institute for Policy Innovation. This article was taken from his recent policy report published by the IPI Center for Technology Freedom titled Prices, Profits and Prescriptions: The Pharmatech Industry in the New Economy. *Copies are available upon request, and also are available on our website at www.ipi.org.*

ROAD MAP TO

Support for tax reform in the U.S. is very strong, and has been strong for some time. Virtually everyone, from wage earners to CPAs and economists understand that our tax code is needlessly complicated, generally unfair, and counterproductive. The question is not whether we need a change. The question is: What kind of change, and how do we get there?

Thus far, tax reformers have been stymied in their attempts to build consensus for tax reform. So the Institute for Policy Innovation is undertaking a major project to provide a "Road Map to Tax Reform," which will point tax reformers in the right direction, and identify the potholes, road hazards, and wrong turns that could scuttle tax reform.

But before we head down the road to tax reform, we need to take a careful look at where we are now—our starting point.

A Costly Trip. The U.S. has "The Most Expensive Government in World History," according to Stephen Moore, author of the first paper in the IPI series. This year, federal, state and local government spending in the U.S. will, for the first time in history, top $3 trillion. It wasn't always so. Historically, the public sector of the U.S. economy was much smaller than it is today. In 1800, the federal government spent only $20 per person; this year it spent $6,500. In 1900, the federal government consumed less than 5 percent of total economic output; while in 1999 it consumed roughly 19 percent. The roots of government expansionism date back to the days of the Great Depression and FDR's New Deal in the 1930s. What might amaze the average reader is that as recently as the 1920s, the federal government was still quite inexpensive and insignificant, accounting for just about 5 percent of national income. Today, it takes between 20 and 25 percent of national income. And government at all levels has swollen from 10 percent to 40 percent. In fact, over the next five years the federal government is expected to spend more money than was spent on World Wars I and II, the Civil War and the Revolutionary War — even after adjusting for inflation. *And in peacetime!*

Road Hazards. Three factors led to the explosion in taxation and government spending:

• The first was the advent of the income tax, which soon became a revenue-generating machine when compared to previous sources of income, primarily tariffs and land sales. As Congress demonstrated in the most recent budget cycle, more funds mean more spending.

• The second force behind the growth of government was the two World Wars and the Great Depression. James Madison once wrote, "Crisis is the rallying cry of the tyrant." Just consider that before World War I the top tax rate was 7 percent. By 1920 it had risen to the once-incomprehensible level of 70 percent. Such tax rates began to stifle economic growth, prolonging the Great Depression. Marginal tax rates that high are a one-way road going the wrong way.

•The third development that has led down the path of massive government spending is the birth of the modern welfare entitlement state, which began with the federal government's first and most expensive income transfer program, Social Security, but increased exponentially in the 1960s when Lyndon Johnson launched the Great Society.

The Brakes Are Gone!!! Once created, these income transfer programs proved virtually impossible to restrain. Although welfare reform has been very successful, that legislation reformed only the cash grant program. The federal government still transfers billions of dollars every year, imposing a huge tax burden on the average family. Just consider:

The Rearview Mirror.

Time for an Overhaul.

Are There Ways to Address These Problems?

PROTECTING YOUR PRIVACY

BY BARTLETT D. CLELAND

"Those who can't do—teach." At least so goes the popular saying. In the increasingly controversial area of privacy concerns the federal government seems to be acting in a similar manner, something like "those who can't figure out—legislate."

The privacy debate has raged on Capitol Hill, inside the Beltway, and to a good extent, across the Web last year. The debate will get hotter this year as privacy becomes one of the biggest technology-related issues debated, resulting in some sort of legislative action regarding privacy protection. This debate will likely generate far more heat than light as some of the basic elements are far from clearly understood or communicated.

Most do not understand the many facets of the privacy debate and closely related issues. Take a simple situation from the past season — gift giving. A gift is wrapped by you and presumably stays a secret until the time of opening by the person intended to receive the gift. Okay, what is the privacy concern involved? Is it that there is some assurance that the intended recipient is the one who will open the gift and see the contents or that it will not be opened early? No, that is a security issue. What about that the gift will be in the box? No, that is also security. How about to know who the giver and receiver are? No, not that either. The only privacy interest in the entire transaction is that all you have to do is fill out the "to" and "from" on the gift tag and then reveal nothing more of yourself.

If you can get this example down then you are well ahead of most. The daily rhetoric routinely mistakes security issues, that is, how safe are items stored on-line or on your computer, with privacy. When a hacker attacks a Web page and grabs the contents, which may include your personal data, then what has developed is an issue of security, not a privacy concern. While some may also consider federal law to dictate the level of protection a company provides, this issue is fundamentally different from privacy protection. The analogy in this instance would be that the federal government in an attempt to limit burglary required every home to purchase and install a deadbolt lock. A clear federal invasion, and a clear analogy to computer security issues.

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One other area of concern is how much customer service the country expects and whether Congress appreciates the impact of the decreased customer service that will result from privacy legislation.

Where collection of information about a consumer is concerned, none of this is much different from the way the world of commerce has worked forever. Take for example, the general goods stores of 100 years ago or even a clothing store today. Would a person take offense if a thoughtful salesperson remembered a customer's name from a previous visit and greeted them accordingly? What if that same salesperson went out of their way to "set back" some of a particular customer's favorite products so that they could pick them up the next time they visited? In some cases we could imagine that customer providing a phone number so that when a limited shipment was coming in they could be notified to make sure they arrived at the store in time to make a purchase. None of these scenarios seem odd or intrusive, in fact we would characterize them as helpful and perhaps as an example of the "good old days" of true customer service.

Understanding these fairly simple points places a person well ahead of most of the country in understanding the real privacy issue. Of course, one important point is that once voluntary practices are put in place by anyone they should be followed, or they really are not practices. When companies or organizations abandon voluntary privacy protection practices, they should not be subject to federal intervention. Rather, they simply should face abandonment by customers whom their actions harm.

The decisions Capitol Hill and the White House make this year and the next will have a profound impact on individual privacy. Understanding the issues and how they relate to everyday life is critical if we are to remain in charge of our own lives, rather than turning over everyday decisions to the government.

Bartlett Cleland is the Director of the IPI Center for Technology Freedom.

IMPACT

IPI Center for Technology Freedom Cohosts Washington Event

Moderator, Adam Thierer (Heritage Foundation), and panelists: Bartlett Cleland (IPI), James Glassman (TechCentralStation .com) and Robert Atkinson (Progressive Policy Institute) at the Washington event.

The IPI Center for Technology Freedom proudly co-hosted a November "scholars and scribes" technology seminar with the Heritage Foundation in Washington, DC. Both organizations addressed critical issues shaping the role between government and the New Economy.

Round one — Panelists from the technology community, including IPI's own Center Director Bartlett Cleland and Center Advisory Board member James Glassman, also host of TechCentralStation.com, charged government with both threatening and facilitating Internet growth. Experts in the field noted the correct government approach in regards to Internet privacy, intellectual property, telecommunications, research and development, as well as the technology antitrust cases.

Round two — Joined by influential technology media representing *USA Today, National Journal's Tech Daily, Washington Internet Daily*, and *Investor's Business Daily*, the combined panel drew an audience representing technology-related legislative, corporate, policy, and media parties. IPI's Visiting Scholar Dr. Merrill Matthews, also a member of Investor's Business Daily's "Brain Trust," shared his insight from both the policy and media worlds.

The IPI Center for Technology Freedom continues to play an integral role in shaping the debate on technology and freedom. We are always eager to spur intellectual discussion and to provide direction in today's technology debate. Watch for future IPI Center for Technology Freedom events in the nation's capital — and beyond.

IPI Makes Waves Around Election Day

ZD TV, a prime technology news network, aired a revealing interview with IPI's Gary Robbins on Election Day. Mr. Robbins, a senior fellow at IPI, exposed a new twist to the Microsoft saga — how the government's unrelenting chase of Microsoft has **already** taken its toll on American families, individuals and the economy. Viewers were indeed surprised to learn that the average American has lost $507 in goods and services, while the economy's cut equals nearly 45,000 fewer jobs.

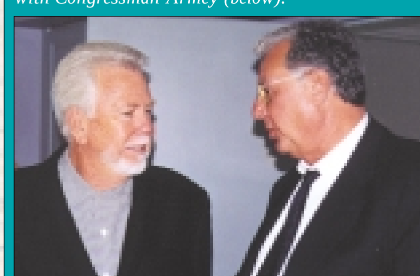
But that's not all. Furthering IPI's impact during this particularly important political season, IPI's work comparing the Bush / Gore tax plans received prominent quotes in a *New York Time's* editorial the Saturday before the election. This opinion piece was mentioned on Monday – right before people headed to the polls — on the **Rush Limbaugh Show**.

It just goes to show that — once again — IPI's commitment to tax analysis achieved the excellent attention it deserves.

IPI's Annual Fundraiser at Texas Stadium scored big with friends and supporters. Even the Cowboys managed to pull off a victory.

Todd Carter of Panda Energy, Congressman Dick Armey and Charles Wylie of Sterling Software enjoy the game (above).

Norman Miller of Interstate Batteries converses with Congressman Armey (below).



Drug Study Goes Global

Hot off the press: IPI's Visiting Scholar Dr. Merrill Matthews takes a new look at the pharmaceutical debate in a recent report for IPI. His analysis of the issue is so compelling that it is now appearing as "advertorials" in publications around the world as a Pfizer Forum. This opinion / editorial ran in *The Economist, The Financial Times*, and *National Review*.

IPI Media Hit Parade: Tour 2000

The Institute for Policy Innovation "went platinum" in July with its experts and studies reaching millions of households. In addition to a Capitol Hill technology seminar and three local events, IPI received numerous citations and interviews in both national and local television, print and radio outlets. Highlights include:

Associated Press, April & June 2000 - IPI's Gary and Aldona Robbins quoted first on the Social Security Earnings Test and later regarding their "analyses prized by Washington officials"

***Forbes*, May 2000 -** Only three months out, the IPI Center for Technology Freedom secures a lengthy reference regarding why *not* to tax the Internet

***Barron's*, September 2000 -** Full-page editorial on drug prices; by IPI's Visiting Scholar Dr. Merrill Matthews

***New York Times*, November 2000 -** Editorial citing "The Fiscal Plans of Al Gore and George Bush: A Comparison"

***Washington Times, Dallas Morning News*, July 2000 -** Editorial by Gary and Aldona Robbins on abolishing the estate tax

***San Diego Union Tribune, Seattle Post-Intelligencer, Boston Herald*, July 2000 -** Jack Kemp quotes IPI's statistics on the estate tax

***Investor's Business Daily*, May 2000 -** Dr. Merrill Matthews on school reform in his monthly "Brain Trust" editorial

***San Diego Union Tribune*, March 2000 -** Full-page economic editorial written by the Robbins' in the Sunday *Insight* section

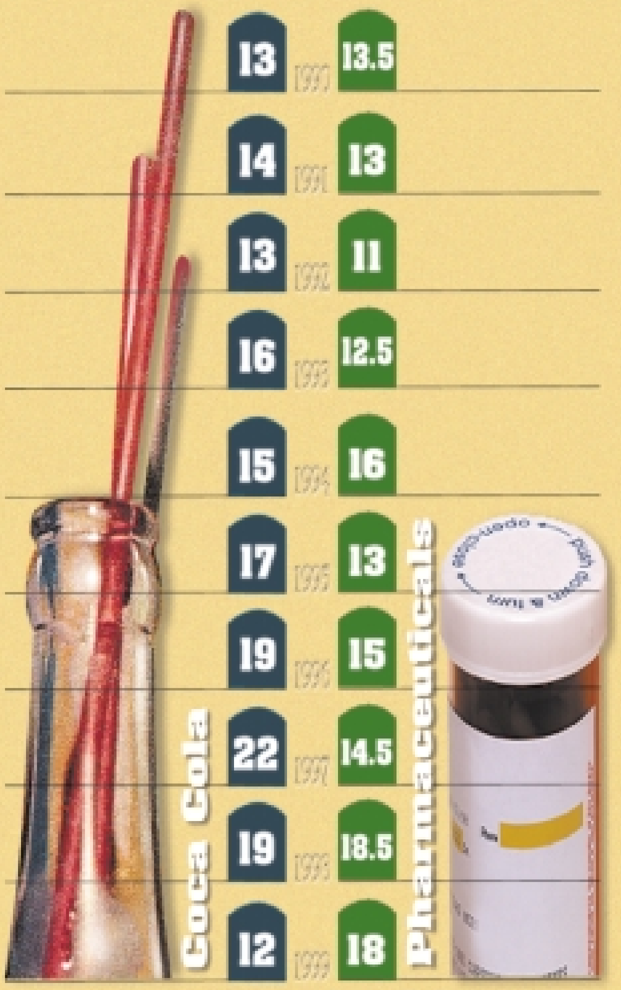
***New York Times*, February 2000 -** IPI analysis charted in multi-page article

***Newsday*, September 2000 -** Robbins' on "Retiring the Social Security Earnings Test"

***Rush Limbaugh Show*, November 2000 -** Robbins' on the Gore / Bush tax plan comparison

CSPAN, February 2000 - Aldona Robbins' Congressional testimony before the House Ways and Means Committee

BOTTLING



Annual Returns as a Percent of Profit

Source: "Fortune One Thousand; Ranked within Industries, "Fortune, April 17, 2000, plus the annual editions since 1990.

PROFITS

It is true that most pharmaceutical companies are profitable. Some critics cite those profits as evidence that drug companies are price gouging. But the real issue is whether drug company profits are comparable with the profits of other New Economy companies or even of such Old Economy companies as Coca-Cola. Over the past decade, Coca-Cola frequently showed higher annual profits than the pharmatech industry.

Looking Ahead in 2001

by Tom Giovanetti
President, IPI

The Board of Directors and staff of the Institute for Policy Innovation (IPI) join me in thanking you for your support of IPI during 2000, and for your interest in our work. Last year saw the birth of our new Centers: The **IPI Center for Technology Freedom**, the **IPI Center for Education Freedom**, and the **IPI Center for Tax Analysis**. We are pleased with the accomplishments of these centers in 2000, and are excited about the opportunity to design and implement free-market public policy solutions in each of these areas in 2001.

Getting free-market, limited government solutions implemented has been a challenge for much of the past year, but at IPI we take the long view, understanding that changes like eliminating the estate tax, privatizing Social Security, and reforming the tax code take time. But we have clearly seen the debate on these and so many other issues move in our direction in the past few years, and we are grateful to have had the opportunity to be agents for such change.

That opportunity comes from you, by circulating our work among your friends and associates, and by using it as ammunition for your letters to the editor and in your discussions with family and friends. But, most of all, it comes from your decision to financially support our work. We thank you for your support, and ask you to consider doing what you can to make sure we hit the ground running in 2001, ready for the challenges and opportunities the new political order will present to us. It could be a very exciting and productive time, and we look forward to the chance to help make America better for our children and grandchildren.

IPI Insights

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TAX REFORM

• Government now spends about $27,000 a year for every family in America — double what it spent in 1960 and 14 times what it spent in 1900, even after adjusting for inflation.

• The winner in the struggle for budget increases has been domestic expenditures. In 1900 about 1 percent of GDP was spent on domestic outlays. By 1950, that figure had grown to about 5 percent, and it now stands at 16 percent.

• Today, government consumes almost half of national income. Thus, we work nearly half of our lives to comply with and pay for government.

The Rearview Mirror. To put it simply, we have taken this road of expanding government spending so long and so far that most Americans cannot remember a time when government didn't play a major role in their pocketbooks and their lives. There are at least four negative results from heading down this path:

1. Continued expansion has led to a more centralized, bureaucratic and less citizen-responsive government. In short, government no longer exists to serve the people; the people exist to serve the government.
2. Bigger government has meant less efficient government. If we are spending 16 times more (as a percent of GDP) on government than we were in 1900, are we getting 16 times the value? Or are we spending more and enjoying it less?
3. Larger government, higher taxes and more regulations are restricting economic growth. As a result, it will take a lot longer to reach our destination than it would have had we taken the other path.
4. In exchange for this increased government, citizens are surrendering their economic freedom and individual liberties. By choosing the leftward path, we almost guarantee that choices in the future will be severely limited.

Time for an Overhaul. America is a vastly different place than it was in 1913, when the constitutional amendment creating the income tax was ratified. It's a vastly different place than it was during FDR's New Deal in the 1930s. It's even been 35 years since Medicare, the jewel of Johnson's Great Society, went into effect.

If we were taking a trip today, we probably wouldn't take an old Model T from 1913, nor would we take a 1930s model Packard. We probably wouldn't even want to take a 1965 Mustang. All of those methods of travel represent old thinking — or what we might call the Old Economy. Even if they were right for their time, they have outlived their usefulness.

Businesses know this. As a result, they are constantly updating, upgrading, downsizing and streamlining. Not so with government.

Just think about it. Government at all levels will spend $3 trillion this year, and many states still use 19th century technology such as manual punch cards for elections, as the recent presidential election demonstrated. We need a change! Tax and spending policies that may have been appropriate 30, 60 or 90 years ago are out of date.

Are There Ways to Address These Problems? Yes, by taking the right path to reform. Stephen Moore argues that we can reduce the size of government if we term-limit public officials, require a supermajority (two-thirds) vote to raise taxes and establish a goal of cutting government taxation and spending to about 25 percent of national income.

If we follow the Road Map to Tax Reform we will maintain a strong and vibrant economy, with opportunity for everyone. Government will be smaller and our paychecks will be bigger. Best of all, we, not Washington bureaucrats, will be in charge of our own destinies—or should we say destinations? IPI

This article is the first in a series, highlighting IPI's Road Map To Tax Reform project. The policy report referenced in this article was written by Stephen Moore, titled The Most Expensive Government in History. *Stephen Moore is Director of Fiscal Policy Studies at the Cato Institute.Copies of this and all IPI reports are available on request, and on our website at www.ipi.org.*