

PRESCRIPTION DRUG PRICES AND PROFITS

By Dr. Merrill Matthews Jr.

For several years the pharmaceutical industry has been under attack by those who are using the industry for political purposes. Some attack the pharmaceutical industry with the goal of establishing a government-run health care system, while others are simply gaining votes and campaign contributions from those with a grudge against the industry.

But the demonizing of an industry doesn't come without costs. And the demonizing of the pharmaceutical industry could result in an enormous cost to society in terms of pain not relieved, diseases not cured, and lives not saved. This paper seeks to answer several common criticisms and expose the absurdity of the accusations.

Criticism #1. The pharmaceutical industry is the most profitable in the country. The implications of this criticism are that drug companies could lower their prices significantly and still be profitable, and that there is some publicly acceptable level of corporate profits that should not be exceeded.

But as any economist or businessperson knows: high prices don't ensure profitability, and low prices don't necessarily mean low profits.

In *Fortune* magazine's annual ranking of the top 500 companies, the 14 companies that make up the "pharmaceuticals" category had a median profit (as a percent of revenue) of 18 percent in 2001 — more than any other industry median. The most profitable drug company on the list was Amgen at 28 percent. But Pharmacia and Abbott Labs both reached only 7 percent profit, and Genzyme recorded a 9 percent loss. On the other hand:

- Coca-Cola had a 20 percent profit;
- Bank of New York made 19 percent and Mellon Financial 33 percent (more than any drug company);
- Microsoft hit 29 percent and Oracle 24 percent;

- Gannett (publisher of *USA Today*) recorded 13 percent while Knight-Ridder reached 15 percent;
- AT&T made 13 percent and SBC Communications earned 16 percent.
- *The Washington Post* can boast of a 10 percent profit, *as much or more than four of the drug companies on the list.*

Yes, most "innovator" drug companies make above-average profits. But that is exactly what you would expect — and want. Any economist knows that the riskier the business the higher the profits must be to induce entrepreneurs to take that risk. A person or company would not assume an above-average risk unless there were the potential for above-average profits. Creating new drugs is one of the riskiest of all businesses, with only about one out of 5,000 new chemical compounds making it to market and only three out of 10 new approved drugs actually meeting or exceeding their research and development costs.

Profits must be high in order to attract risk-taking companies. Yet Coca-Cola made more money in most years of the 1990s than the median pharmaceutical company, and no one accuses that company of price gouging, or of taking above-average risks to accomplish some great social good.

Criticism #2. Prescription drug prices are too high. Too high in comparison to what? The average prescription drug costs about \$50. A family of four going to the movies can easily spend \$25 for admission, and another \$25 on refreshments. Surely a prescription drug that relieves pain or cures a medical condition is worth as much as a night at the movies.

Or consider that a "clean, comfortable" room at moderately priced motels can also cost around \$50 — for only one night. Better hotels can cost \$150 to \$200 a night or more — four times the average cost of a prescription drug.

People regularly and voluntarily spend as much or more money than they do for a prescription on things they want and think nothing of it — even though they may get more benefit from the drug. But they don't complain to their elected representatives about the cost of movies like they do the cost of drugs.

Criticism #3. Drug prices are high because pharmaceutical companies pay their CEOs outrageously high salaries. While many of the drug companies pay their CEOs well, those salaries are not out of line with other companies their size. Indeed, they may be on the low side.

USA Today recently ranked total “compensation packages for 103 CEOs at 100 top companies,” including the “potential value of stock option grants,” and guess what? Lots of CEOs did much better than drug company executives.

Oracle was ranked first because the CEO's salary, plus add-ons and potential stock options, brought his total compensation to \$706 million in 2001. Cisco Systems and SBC communications ranked second and third, respectively. IBM ranked fifth. Even the CEO of Coca-Cola came in ninth with \$100 million — 30 percent more than the highest-paid drug company CEO.

GUESS WHO'S NOT AMONG THE TOP PAID CEOs*

COMPANY	CEO	SALARY (IN MILLIONS)
1. Oracle	Lawrence J. Ellison	\$706.1
2. Cisco Systems	John T. Chambers	\$226.7
3. SBC Communications	Edward J. Whitacre Jr.	\$154.9
4. Phillip Morris	Geoffrey C. Bible	\$131.7
5. IBM	Louis V. Gerstner Jr.	\$127.3
6. Lehman Bros. Holdings	Richard S. Fuld Jr.	\$127.0
7. Sprint	William T. Esrey	\$113.7
8. Tyco International	L. Dennis Kozlowski	\$112.5
9. Coca-Cola	Douglas N. Daft	\$100.6
10. EDS	Richard H. Brown	\$81.0

*Compensation packages, including stock options, 2001.

Source: *USA Today*, March 25, 2002.

And yet:

- Pfizer's CEO came in at 15 on *USA Today's* chart, even though Pfizer is the fifth largest company in the world, according to the *Wall Street Journal*.
- Abbott Laboratories' CEO ranked 23, Schering-Plough was 51, Eli Lilly 55 and Johnson & Johnson 88, even though J&J is the 15th largest company in the world.

But why stop with corporate CEOs? According to *Parade* magazine:

- TV newswoman Diane Sawyer made \$10 million in 2001.
- Actress Jennifer Lopez took in \$14.4 million, and singer Brittany Spears raked in \$38.5 million.

- Baseball player Mike Piazza got \$15 million, basketball great Shaquille O'Neal received \$29 million and ex-con Mike Tyson brought in an astounding \$48 million.

And none of these “stars” employ 100,000 people all over the world. *Where's the outrage over THESE exorbitant incomes?*

Here is the real irony. There is a general awareness in our society that those who add a lot of value to it, such as teachers, often don't receive nearly the compensation they should. Yet the pharmaceutical industry adds tremendous value in its quest to relieve pain and suffering and cure disease and pays its employees better than average — but critics still complain.

Criticism #4. Drug companies are “profiting from pain.” Actually, drug companies profit from the *relief* of pain and suffering.

People must have food on a daily basis, yet no one says that farmers and grocers are profiting from starvation.

When people travel, they usually need a place to stay at night. Fortunately, there is a system of hotels and motels across the country ready to meet the travelers' needs. But no one seriously claims that hotels are profiting from homelessness. To the contrary, travelers who need a place to stay are thankful the hotel industry provides lots of options on price, quality, service and convenience.

Conclusion. Like food and hotels, the drug industry makes a product that many people want and need. Unlike those industries, the innovator drug companies take enormous financial risks. That most drug companies manage to earn a profit, especially in troubled economic times, should elicit praise, not criticism.

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