IPI Institute for Policy Innovation

Quick Study

A Policy Report Summary by the Institute for Policy Innovation

Prices, Profits and Prescriptions:
The Pharmatech Industry in the New Economy

A Summary of IPI Policy Report #157

By: Merrill Matthews, Jr., Ph.D.

There have been many complaints about prescription drug prices lately; critics seem to think they are too high, and point to drug company profits as proof. But would imposing price controls on drugs be good policy for the public, states and the nation? Would such policies reduce or eliminate drug manufacturers' research and development efforts? Are there deadly or debilitating diseases that won't be treated or cured if price controls are implemented? How many people would die for lack of a new drug that might have been developed had price controls never been adopted?

While price-control advocates are good at recognizing the high cost of a drug, they never take time to count the high cost of *not* having it. A government decision to make prescription drugs more "affordable" by imposing price controls would mean less money available for research and development. Money will be saved, but lives will be lost.

Are Prescription Drugs Expensive?

Some drugs are very expensive, others aren't. What's the difference? Research and development. As Figure 1 shows, pharmaceutical companies will spend about $22.4 billion in 2000 developing and testing new drugs, as compared to about $4 billion for all other countries combined.

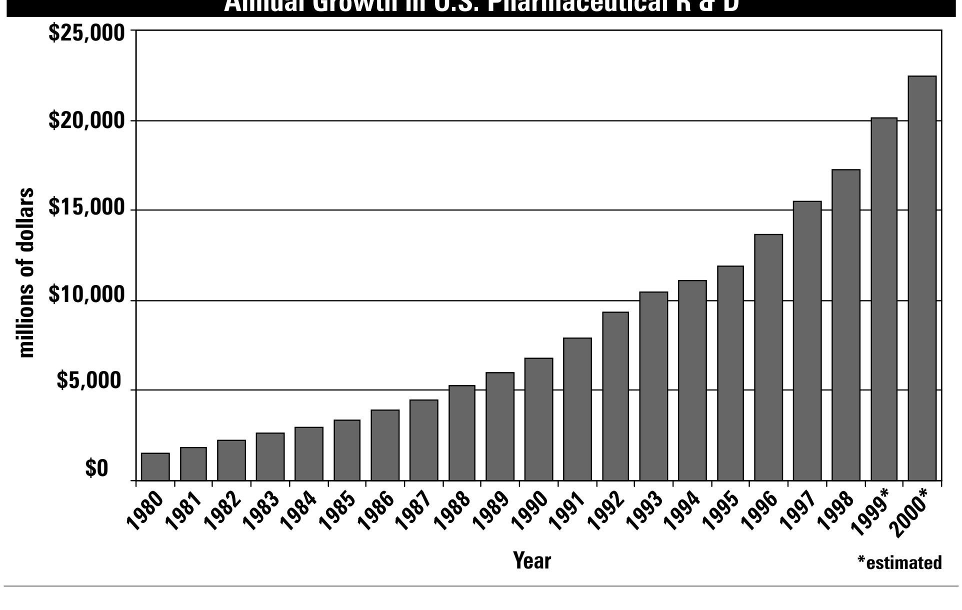
Pharmaceuticals in the New Economy

Not all drugs are expensive; most over-the-counter drugs are very affordable, which highlights an important distinction. There are really two pharmaceutical industries: one that mass produces aspirin, cold medicines, ointments and other over-the-counter (OTC) drugs and one that spends billions of dollars each year creating and developing new prescription drugs that relieve pain, cure disease and save lives. The OTC market fits nicely in an Old Economy model where there are some research costs, but competition is high and prices are low.

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.

Figure 1

Annual Growth in U.S. Pharmaceutical R & D



For a New Economy company, the primary barrier is the cost of developing the intellectual property, which may be patented in order to protect the monopoly.

In a speech delivered in May in San Francisco, former Treasury Secretary Lawrence Summers said that at the heart of this thing called the New Economy “must be the move from an economy based on the production of physical goods to an economy based on the production and application of knowledge” — or what he calls “knowledge goods.” Thus, “An information-based world is one in which more of the goods that are produced will have the character of pharmaceuticals or books or records, in that they involve very large fixed costs and much smaller marginal costs.” And that change bears significantly on the nature of economic incentives. According to Summers, 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.”

Are Drug Company Profits Too High?

It is true that most pharmaceutical companies are profitable — with profits averaging about 18 percent of revenue in 1999, according to *Fortune* magazine. Some critics cite those profits as evidence that drug companies are price gouging. The real issue is whether drug company profits are comparable with other New Economy, or even some Old Economy, companies.

Table 1 tracks profits as a percent of revenues for several companies over the past decade as compared to the average profit ranges of several pharmaceutical companies. According to the table:

- Coca-Cola frequently showed higher profits than the pharmatech industry average.
- And Microsoft had significantly higher profits, while Oracle was only slightly below the pharmatech average.

Moreover, as shown in Figure 2, a number of industries had average annual profits very close to the pharmaceutical industry’s.

So, 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, and even some Old Economy companies, that deal in intellectual property or other patentable or copyrighted products.

People Want What Drug Companies Sell

Which brings us to an important point: drug companies are not profitable because they charge so much for many prescriptions; *they are profitable because they produce products that doctors and their patients want*. However, while a company like Coca-Cola stays profitable by promoting the same

Table 1

Annual Returns as a Percent of Profits

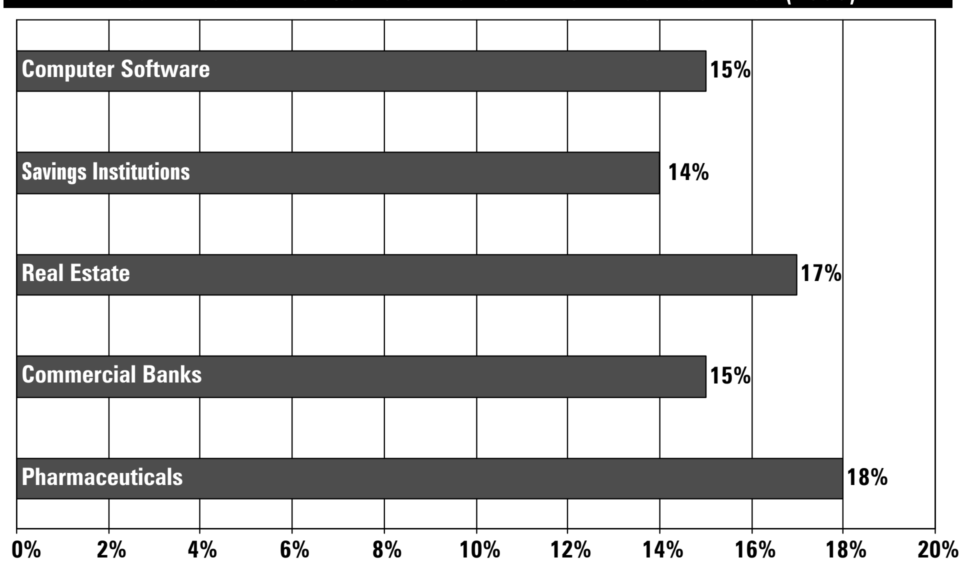
Year[1]	Coca-Cola	Microsoft[2]	Oracle[2]	Walt Disney[2]	Pharm. Ind.
1990	13				13.5
1991	14				13
1992	13				11
1993	16				12.5
1994	15			11	16
1995	17			11	13
1996	19	25	14	6	15
1997	22	30	14	9	14.5
1998	19	31	11	8	18.5
1999	12	39	15	6	18

[1] Each year listed was reported in the subsequent year’s edition of Fortune (e.g., 1999 was reported in the 2000 edition).

[2] Fortune did not cover all years.

Figure 2

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



product year after year, pharmaceutical and computer software companies make their money by continually releasing new or upgraded products.

As a result, while total spending on pharmaceuticals has been growing rapidly — averaging a 13.7 annual increase between 1995 and 1999 — most of that spending is due to 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. [See Table 2.]

Do Seniors Need a Prescription Drug Benefit?

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 there is a problem.

Currently, 65 percent of seniors already have some type of coverage for prescription drugs. Of the 35 percent who do not have coverage, many of them are healthy and face relatively low expenses. Most have made a conscious decision — which may be reasonable given the fact that they are healthy — not to purchase drug coverage. In other words, just because 35 percent of seniors don't have supplemental coverage doesn't mean they have serious health care problems or high drug expenses.

The Role of Competition in Real Markets

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.

Take direct-to-consumer (DTC) advertising, for example. Congress has already adopted some policies that have enhanced competition among drug companies, which explains their heightened visibility. In just 10 years DTC advertising has increased from $55 million (1991) to an estimated $1.8 billion this year. However, most of that growth came after 1997, when the Food and Drug Administration (FDA) loosened some of the restrictions on DTC ads. For example:

- In the first half of 1998, pharmaceutical marketers spent $273.3 million on DTC television ads, an increase of 312.5 percent over the same period in 1997.
- While drug companies spent 19.6 percent of their total DTC dollars on TV ads in the first half of 1997, they spent 47.7 percent in the first half of 1998.

And those ads have had an impact on consumer behavior. Prior to the change in guidelines, 41 percent of the physicians surveyed by IMS Health said they had observed an increase in patients' requests for brand name drugs. After the change, 65 percent of the physicians surveyed noticed an increase in brand-name requests.

While increased advertising expands information and enhances brand recognition, it doesn't necessarily increase competition. If there is only one product treating a specific illness or medical condition, the manufacturer can still make monopoly profits. Fortunately, many medical conditions are being treated with a growing number of products.

Limits to a Prescription Drug Market

True, the prescription drug market doesn't work exactly like a normal market for three reasons:

(1) Patents create a barrier to entry. But, as has been pointed out, drug companies are still free to develop different drugs that treat the same disease or medical condition.

(2) A physician who doesn't have to pay for the drug fills out the prescription for a patient who does. But many physicians are sensitive to costs and want to prescribe the product with the best effect at the lowest cost, and they are increasingly willing to make cost considerations a factor.

(3) Most patients have insurance that insulates them from the price of prescription drugs, which means

Table 2

Sales Growth Rates of U.S. Prescription Drugs

Year	Price	Volume, mix & new products	Total
1990	8.4	6.2	14.6
1991	7.2	6.7	13.9
1992	5.5	3.4	8.9
1993	3.0	5.2	8.2
1994	1.7	6.4	8.1
1995	1.9	7.8	9.7
1996	1.6	8.5	10.1
1997	2.5	11.7	14.2
1998	3.2	12.5	15.7
1999	4.2	14.6	18.8

Source: IMS Health, "Retail and Provider Perspective, 2000," reproduced in "Pharmaceutical Industry Profile 2000," Pharmaceutical Research and Manufacturers of America, Washington, D.C., March 2000.

they are not price sensitive. As a result, they want the best drug available, irrespective of the price.

Nevertheless, the prescription drug market could be more competitive than it is now.

Increasing Competition by Deregulation

If Congress is concerned about drug company prices and profits, the proper response is to adopt policies that encourage competition, not restrict it as price controls would do.

Indeed, some steps in this direction have already been taken. For example, in 1991 the FDA published regulations intended to accelerate the review of drugs targeting life-threatening illnesses. And the faster a drug can move through the process and hit the pharmacies, the more competitive the market will be.

In addition, 1997 legislation attempting to speed up the drug approval process and loosen restrictions for advertising has played a dramatic role in increasing advertising over radio and television. Consumers are increasingly becoming familiar with prescription drug products and what they do. That's important since a knowledgeable consumer and brand identification are necessary to a competitive market.

Conclusion

True, the pharmaceutical industry will likely never be as competitive as some industries. Several factors, such as patent protection and the price insulation for consumers, 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?

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Editor & Publisher . . . . Tom Giovanetti

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Direct all inquiries to:
Institute for Policy Innovation
250 South Stemmons, Suite 215
Lewisville, TX 75067
(972) 874-5139 (Voice)
(972) 874-5144 (FAX)

Email: ipi@ipi.org
Internet Website: www.ipi.org

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