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Answering Critics of the Pharmaceutical Industry

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Complaints about prescription drugs have escalated of late. Critics contend that drugs cost too much and point to drug company profits as the reason why. They also claim that the pharmaceutical industry is our nation's most profitable and that price controls would make drugs more affordable, especially for seniors — as they appear to in Canada and some other developed countries.

Are these critics right? Let's see.

❶ The Pharmaceutical Industry Is The Most Profitable In The Country

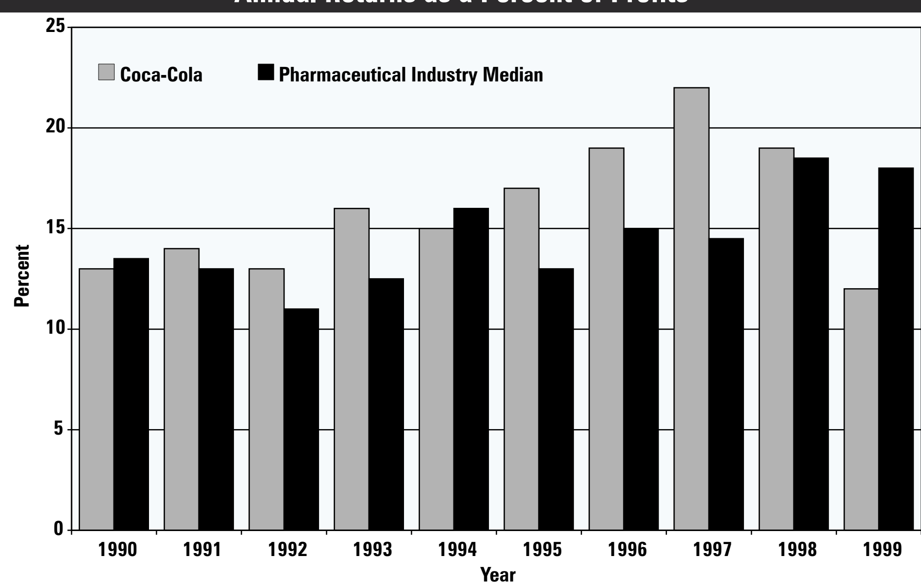
The pharmaceutical industry, on the whole, is profitable. But some drug companies lose money, and many non-drug companies make more than the drug manufacturers.

The assessment of profitability comes from *Fortune* magazine's annual survey of the top 1,000 companies. According to the survey published in April 2000, 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) in 1999. Amgen had the highest profit at 33 percent, with American Home Products the lowest, having lost 9 percent. Most companies ranged around 15 to 20 percent.

However, 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 in 1999, according to *Fortune*. As the figure 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.

Gannett, publisher of *USA Today*, made 17 percent — right up there with the drug companies — and 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*.

Annual Returns as a Percent of 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 spend a lot of money up front researching and developing those products.

Pharmaceutical companies spent about $24 billion developing and testing new drugs in 2000 — about 21 percent of their sales, more than any other industry and twice as much as the computer software industry. However, although software companies spent less than drug companies on R & D, Microsoft reported a 39 percent profit last year, while BMG Software reported 28 percent.

❷ Pharmaceutical Companies Are So Profitable Because They Charge High Prices

While total spending on pharmaceuticals has been growing rapidly — averaging a 13.7 percent annual increase between 1995 and 1999 — most of that spending is due to an increase in new products and 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. Thus, *drug companies aren't profitable because they charge so much; they're profitable because they make products that patients and their physicians want.*

❸ Drug Companies Make So Much Money Because Their Products Are Patented

In many other industries — the soft drink industry, for example — copywrited, patented or trademarked products compete strongly, advertise heavily, keep their prices low and still earn high profits. But nobody cares because they aren't prescription drugs.

The drug industry is very competitive. No drug company has more than 7.2 percent of the U.S. market. For example, among the top 20 advertised prescription drugs in 1998, four were competing allergy medications.

True, the prescription drug market doesn't work exactly like a normal market, but that's primarily because physicians who don't have to pay for the drugs fill out prescriptions for patients who are usually insulated from the cost of drugs by their insurance.

But the prescription drug industry could be even more competitive than it now is — which would have a price-lowering effect — if only the industry faced fewer regulations and consumers demanded value for their drug dollars. Both are possible, but only if changes are made.

❹ Drugs Are Expensive Because Of Advertising Costs

Every Sunday newspaper is filled with advertising flyers for department stores, office products, computers, cars, food and clothing. Yet no one says they can't afford food because all the grocery stores advertise. And does anyone really think they would be able to get a computer for less money if none of the computer manufacturers and retail outlets advertised?

Drug companies are increasingly advertising direct-to-consumer (DTC). In just 10 years DTC advertising has increased from $55 million (1991) to an estimated $1.8 billion in 2000. However, most of that growth came after 1997, when the Food and Drug Administration (FDA) loosened the restrictions on DTC ads.

Critics claim those advertising dollars drive up the cost of drugs. In fact, they create more informed consumers and eventually may lower drug costs.

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.

That is precisely the type of consumer behavior we want. Increasing consumer awareness, information and demand is the first step in the market process that eventually can lead to price competition among drug manufacturers.

❺ Price controls would lower drug costs.

Many critics of the drug industry contend that the quickest, most effective way to ensure that Americans have access to affordable prescription drugs is to impose price controls, as many other industrialized nations including Canada have done.

While it is true that residents of countries with prescription drug price controls pay less for some drugs, they pay more for others — if they can get them at all. For example, an April 1999 comparison of drug costs in several countries by Prof. Patricia M. Danzon of the University of Pennsylvania's Wharton School of Business found that "Canadian prices are between 13 percent lower and 3 percent higher than the U.S., depending on the price index used." Moreover, generic drugs, which make up 45 percent of the American prescription drug market, tend to cost more in Canada than in the U.S.

However, the biggest problem may be access. According to Dr. William McArthur, a Canadian physician and formerly the chief coroner in Vancouver, between 1994 and 1998 the Canadian government considered some 400 new drugs but "ruled that only 24 — or 6 percent — were substantial improvements over their predecessors."

In addition, each of the 10 provinces has a review committee that must approve the drug for the province's formulary. "Of 99 new drugs approved by the federal government in 1998 and 1999, only 25 were listed on the Ontario formulary," according to Dr. McArthur.

Since Canadians must pay out-of-pocket for unapproved drugs, demand is low, and pharmacies have little incentive to stock them. As a result, many Canadians travel to the U.S., paying out-of-pocket to get the drugs they need.

Conclusion

While it is true that many prescription drugs are expensive, those drugs — and the millions of dollars in research that created them — benefit millions of Americans every day. If we want that research to continue, we have to realize that drug company profits aren't a problem — they're the solution.

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