Lower U.S. Prescription Drug Prices Are Vital to Both Patients and Drug Makers—

But Instead, U.S. Prices Have Been Rising Rapidly Relative to Those in Other Wealthy Nations

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I. U.S. DRUG PRICES RISING RAPIDLY RELATIVE TO OTHER WEALTHY NATIONS

The prices that brand name prescription drug makers charge in the United States have been rising relative to their prices for the same drugs in other industrial democracies. This is clear from analysis of the latest data on eight nations collected by the Canadian government's Patented Medicines Price Review Board.[1]

As shown in Exhibit 1, in 2000, brand name prescription drug makers' prices in the U.S. were 60 percent above the average that they charged in Canada and six wealthy western European nations.[2] In 2001, U.S. prices exceeded the average prevailing in those seven nations by 73 percent.[3] And in 2002, U.S. brand name drug prices climbed to 77 percent above the 7-nation average.[4] Thus, over these years alone, the excess in U.S. prices grew by more than one-quarter (78 percent excess divided by 60 percent excess equals 130 percent).

Exhibit 1

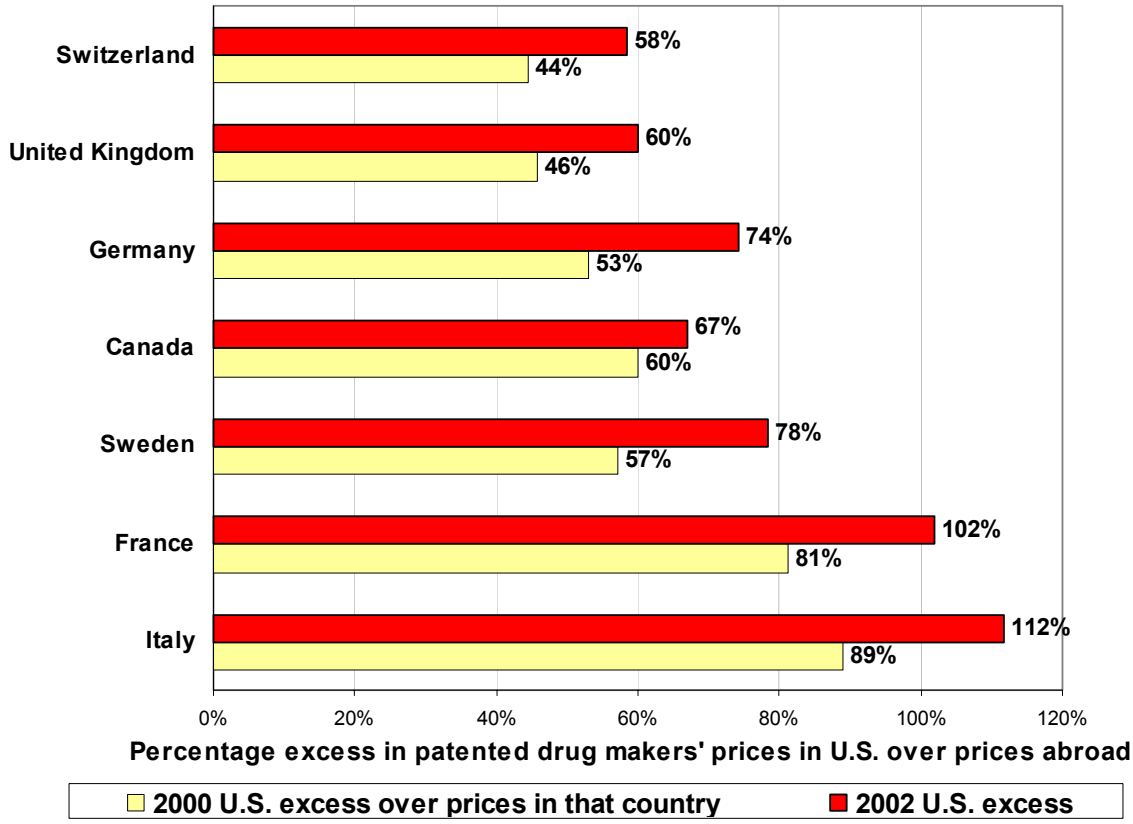
Brand Name Prescription Drug Makers' U.S. Prices Rising farther above 7-Nation Average, 2000-2002

	U.S. Price Excess
2000	60%
2001	73%
2002	78%

Exhibit 2

FROM BAD TO WORSE:

U.S. Brand Name Prescription Drug Prices Are Rising farther above Prices in Seven Nations



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Source: Calculations from Patented Medicine Prices Review Board annual reports for 2000 and 2002, tables on "Trends in Drug Prices and Expenditures."

The U.S.-foreign price gap rose at visibly different rates for different countries, as Exhibit 2 illustrates. From 2000 to 2002, the excess in U.S. brand name prescription drug prices over those charged for the same drugs in Canada rose by just one-ninth, for example. The U.S. - Italy price gap grew by one-quarter, and the U.S.-Germany gap grew by fully two-fifths. Such differences help indicate that the growth in international price disparities cannot simply be attributed to fluctuating exchange rates.[5]

Rather, the differences stem largely from the different public policies on drug pricing and costs implemented in each nation. Drug makers have been raising prices in the U.S.[6] Meanwhile, other nations have restrained prices and total drug costs in various ways—including implementing across the board price cuts in some countries,[7] and putting prescription drug spending on a budget.

Importing drugs from Canada is a politically appealing way to win lower prices, as it relies on vague foreign actions, not direct U.S. price regulation. Still, it is not necessary to launder our pills in a Canadian washing machine in order to clean them. And it may not even be possible to lower prices in this way. Drug makers could limit reimportation simply by holding down supplies in Canadian warehouses, or by other methods, as we testified almost two years ago.[8]

II. DEMANDS FOR RELIEF

Soaring U.S. prescription drug costs have prompted demands for several kinds of relief. Two of the most popular demands have been better coverage through a Medicare prescription drug benefit, and lower prices through importing medications from Canada or other nations.

High U.S. drug prices figure prominently in generating and addressing each of the two demands. High prices have helped to hike pressure for relief, and those same high prices make it difficult to craft an affordable Medicare benefit. High prices inspire pressure to import from Canada in pursuit of relief. In the absence of government action, many tens of thousands of American patients have individually sought more affordable prescription drugs in Canada and elsewhere, but many others remain in need.

Prescription drug manufacturers and their friends argue that high U.S. drug prices are a pill that Americans will just have to keep swallowing if we want to benefit from research to develop valuable new drugs.[9] [10]

The drug companies and their friends are wrong for two reasons. First they ignore the very real opportunities to offset lower U.S. drug prices with higher volume of prescriptions. Second, they recklessly imagine or pretend that the growing gap between U.S. and other wealthy nations' prices is sustainable.

A. A prescription drug peace treaty

Drug makers and their friends imagine that high prices are essential to high profits and to generating enough money to finance vital research to develop innovative drugs. They are wrong.

The U.S. can craft a prescription drug peace treaty that guarantees drug makers current profits—returns on equity— and protects their current abilities to finance research, even if their prices are lowered substantially—to Canadian levels or below. *And this peace treaty would provide all needed prescription drugs—at a surprisingly affordable cost.*

Consider this example. Suppose that the prices of brand name prescription drugs (not generics) are cut by roughly 40 percent, about the levels prevailing today in Canada. Drug manufacturers would suffer a loss of revenue of about $50 billion this year.

But every cent of lost revenue could be replaced by higher volume. Here's how.—

First, lower drug prices lead patients to demand greater quantities of medications. More patients can now afford to fill prescriptions, or to fill them in accord with doctors' orders. Merrill Lynch estimates a price-elasticity of demand close to minus 1.0 for Medicare patients. [11] But suppose that, in practice, the price-elasticity is only minus 0.5. That would indicate that volume growth would replace about one-half of the revenue lost through lower prices.

Second, patients who are still not able to afford needed medications would be protected by new public subsidies.

Together, the higher private market demand and the publicly-subsidized demand would aim to generate sufficient volume, at the newly lowered prices, to generate the same total revenue that prevailed before prices were cut.

Third, drug makers would also be paid the extra costs of manufacturing the additional pills that patients need. We have estimated this manufacturing cost at about $5 billion annually, to which must be added $4 billion for retail dispensing.

Together, these three changes could raise the public share of prescription drug spending from today's 21 percent to about one-half.

The results:

- all needed prescriptions are filled (roughly a one-third increase in the volume of medications prescribed—from 3 billion to 4 billion annually);
- drug makers' returns on equity are protected, preventing any erosion in financial capacity to finance research; and
- total rise in prescription drug spending of $9 billion.

B. Growing dependence on the U.S. market is illusory

Spending on prescription drugs in the U.S. has soared in recent years, we calculate.[12] As shown in Exhibit 3, total drug spending rose almost five-fold in the thirteen years from 1990 to 2003. Drugs' share of U.S. health care spending doubled, from 6.5 percent to 13.0 percent during these years.

Exhibit 3

U.S. Prescription Drug Spending, 1990 – 2003, $ Billion

year	retail	total
1990	$40,300	$45,485
1995	$60,800	$68,623
2000	$121,500	$137,133
2003	$189,087	$213,416

The increase in spending is attributable to a combination of higher prices on existing drugs, introduction of new drugs with high prices, and changes in rates of use of drugs, including the shifting of patients from lower-price to higher-price drugs.

As drug spending rises, more and more attention is focused on the disparity in prices prevailing in the U.S. and in other nations. For many years, the drug makers and their friends tried to deny that U.S. prices were higher. Now, they say, higher prices are good for us, or at least a necessary evil. Other nations have governments that regulate prices, so the American patient, employer, or taxpayer must make up the difference. This was more bearable a decade ago, when drugs were a much smaller share of health spending. It is rapidly becoming intolerable today.

Drug makers and their friends assert that high U.S. prices are the products of a free market. This is simply not true—in large part because patents themselves are government-granted monopolies that bar competition. [13]

But even if high U.S. prices were, somehow, a product of a legitimate free market, drug makers engage in fantasy if they imagine that high U.S. prices will long remain politically tolerable. There are three reasons.

First, despite high profits and claims of high investment in research, fewer new drugs have been brought to market in recent years.[14] Industry critics have claimed that drug spending growth in the U.S. has rested increasingly on higher prices and marketing, not on valuable new medications. These claims, and the findings that support them, undermine drug makers' assertions about the value of their research and, therefore, the importance of high U.S. drug prices to the development of new medications.

A second reasons high prices are becoming intolerable: as U.S. spending on drugs rises, more Americans find it difficult to afford the medications their physicians prescribe.

Third, drug makers have become increasingly dependent on the U.S. market for revenue and profit. It is not possible to extract the revenue growth that the drug makers desire, to sustain their stock prices, from so narrow a share of the world market. As shown in Exhibit 4, the U.S. share of drug makers' world-wide revenues rose from almost one-third in 1996 to almost one-half in 2002. [15] Sales in the U.S. were roughly 95 percent of the North American total. The 2002 international distribution is shown in Exhibit 5. (Note that our high prices mean that Americans receive far less than half of the world's prescription drugs.)

Just as important, we estimate, drug makers extract between two-thirds and three-quarters of their profits from the citizens of the United States. [16] According to some industry sources, drug makers' investment in research in recent years has been roughly equal to their profits in the United States.

Imagine a soaring tower, becoming more narrow at its base even as it rises higher. This tower becomes less and less stable over time. It will topple if it is allowed to continue to rise and narrow. And that toppling is what will truly harm research. Therefore, all who actually are concerned about secure, stable, and durable financing for innovative pharmaceutical research should worry deeply about the rise in U.S. drug prices relative to those in other wealthy nations, and about the industry's growing dependence on the U.S. market.

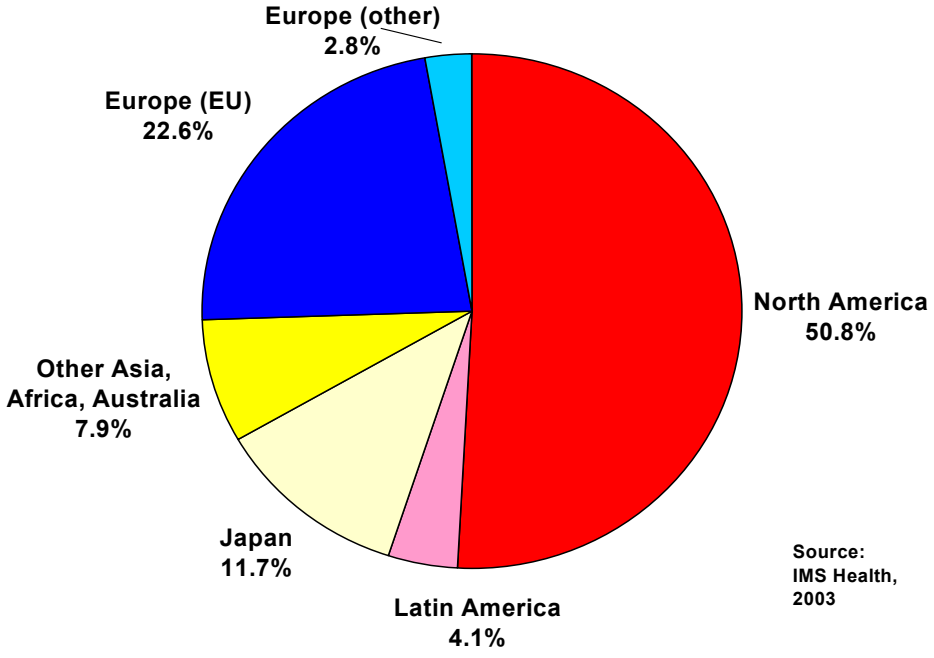
Exhibit 4

Drug Makers' Soaring Dependence on the North American Market, 1996 - 2002

year	Share of drug makers' revenue garnered from North American market
1996	34.7%
1998	41.5
2002	50.8

Exhibit 5

U.S. BUYS HALF OF WORLD'S DRUGS, 2002



Drug makers' growing dependence on the U.S., soaring U.S. drug costs, and rising pharmaceutical insecurity among Americans, combine to threaten first the regime of high U.S. prices, and second the regime of drug maker's extreme over-dependence on the U.S. market.

Drug makers may claim that the prices and profits they garner in the U.S. are endorsed by a genuine free market, and they may claim that, without these high prices and profits, innovation will suffer. But these claims, even if true, will soon be ignored by U.S. voters and legislators. A new way will have to be found to generate the funds needed to finance research.

The drug peace treaty described earlier, with its lower prices and filling of all needed prescriptions, will help sustain drug makers' revenues for several years. The U.S. share of the drug makers' revenues is unaffected.

Lower prices for payers and prescription drug security for patients would probably persuade enough Americans to continue to bear their nation's current share of drug makers' revenue and profits for a few more years. This would allow time to plan a transition to a fair international division of the burden of paying for pharmaceutical innovation and profits—both among wealthy nations, and among rich, middle-income, and impoverished nations.

For these reasons, we urge the world's drug makers to rapidly move to negotiate a prescription drug peace treaty in the U.S., one that exchanges lower prices for higher volumes of sales and guaranteed protection of profits and capacity to finance research.

These negotiations will be difficult and uncertain, but their results are predictably better for drug makers than huddling in today's pharma castle, surrounded by high walls and pill boxes full of economists, perched on the edge of the ocean, on a cliff that is being undercut by waves of public anger over high drug costs.

Only one thing is certain: the longer the world's drug makers wait to make a sustainable deal with the United States government and public, the weaker the industry's bargaining power and credibility will be, and the angrier and less reasonable the government and public will be.

NOTES

[1] See Patented Medicine Prices Review Board, "Trends in Drug Prices and Expenditures," *2002 Annual Report*, Ottawa: The Board, 30 May 2003, Figure 13, http://www.pmprb-cepmb.gc.ca/CMFiles/ar2002e21LEF-6252003-6142.pdf

[2] Health Reform Program calculations from Patented Medicine Prices Review Board, "Trends in Drug Prices and Expenditures," *Annual Report 2000,* Ottawa: The Board, 11 June 2001, Figure 8, http://www.pmprb-cepmb.gc.ca/PDF/ar00e7.pdf. Note that these are unweighted averages.

[3] Health Reform Program calculations from Patented Medicine Prices Review Board, "Trends in Drug Prices and Expenditures," *2001 Annual Report*, Ottawa: The Board, 21 June 2002, Figure 10, http://www.pmprb-cepmb.gc.ca/PDF/ar2001/ar2001-e7a.pdf

[4] Health Reform Program calculations from Patented Medicine Prices Review Board, "Trends in Drug Prices and Expenditures," *2002 Annual Report*, Ottawa: The Board, 30 May 2003, Figure 13, http://www.pmprb-cepmb.gc.ca/CMFiles/ar2002e21LEF-6252003-6142.pdf

[5] For example, although Italy, Germany, and France all use the same currency, the euro, the gaps between U.S. prices and theirs grew at substantially different rates for brand name prescription drugs in 2001 and again in 2002.

[6] See, for example, ***Out-of-Bounds:*** *Rising Prescription Drug Prices for Seniors*, Washington, DC: Families USA, July 2003, http://www.familiesusa.org/site/DocServer/Out_of_Bounds.pdf?docID=1522.

[7] See, for example, Vanessa Fuhrmans and Scott Hensley, "Drug Makers Are More Vocal Against Europe's Price Controls," *Wall Street Journal* , 13 December 2001; Vanessa Fuhrmans and Gautam Naik, "In Europe, Drug Makers Fights Against Mandatory Price Cuts," *Wall Street Journal*, 7 June 2002.

[8] Alan Sager, Americans Would Save $38 Billion in 2001 If We Paid Canadian Prices for Brand Name Prescription Drugs: How to Win Those Savings and Use Them to Protect All Americans against High Drug Costs without Hurting Drug Makers or Drug Research, Invited testimony before the U.S. Senate Commerce Committee, Subcommittee on Consumer Affairs, 5 September 2001.

[9] See, for example, James K. Glassman and John R. Lott, "The Drug World's Easy Riders," Commentary, *Wall Street Journal Online,* 23 July 2003, http://online.wsj.com/article/0,,SB105890849846578000,00.html?mod=health_home_inside_today_left_column.

[10] John E. Calfee, "The High Price of Cheap Drugs: The House Is Tempted by a Terrible Idea," *Weekly Standard,* 21 July 2003.

[11] Merrill Lynch, *A Medicare Drug Benefit: May Not Be So Bad*, June 23, 1999.

[12] Cathy Cowan and others, "National Health Expenditures, 1998," *Health Care Financing Review,* Vol. 21, No. 2 (Winter 1999), pp. 165-196; Cathy A. Cowan and Others, "National Health Expenditures, 1999," *Health Care Financing Review*, Vol. 22, No. 4 (Summer 2001), pp. 77-110; Katharine Levit and others, "Inflation Spurs Health Spending in 2000," *Health Affairs*, Vol. 21, No. 1 (January-February 2002), pp. 172-181; and Katharine Levit and others, "Trends in U.S. Health Care Spending, 2001," *Health Affairs*, Vol. 22, No. 1 (January-February 2003), pp. 154-164.

We have estimated that retail spending is 88.6 percent of total prescription drug spending, which includes the cost of (non-retail) prescription drugs used in hospitals and nursing homes.

[13] The United States government emphatically rejects PhRMA's claims that a free market legitimizes drug makers' prices, or that cutting prices is dangerous, by taking a 42 percent (or so) price discount for medications for the Veterans Administration and the military, and by taking an 18 percent (or so) rebate for the Medicaid program. This is the sort of thing foreign governments have long done for all their citizens.

We point to these six specific indicators of the absence of a free and competitive market:

1. Prevailing price disparities are themselves evidence of the lack of a free market for prescription drugs. While different payors today pay very different prices for the same drug, prices would tend to converge if there were a free market. In a free market, price competition would result in the same price throughout the market.

2. The drug industry's high U.S. prices—prices many times marginal cost of production—also suggest that nothing close to a freely competitive market is at work here. In a free market, prices tend to track marginal costs.

3. The industry's monopolistic (or oligopolistic) character in many sectors gives drug manufacturers tremendous power to set prices. Recent reports have documented that there is only limited competition within many major categories of medication. For example, in four important categories of drugs, the top-selling three drugs accounted for 71-90 percent of 1998 U.S. retail sales. (National Institute for Health Care Management, *Prescription Drugs and Intellectual Property Protection*, Washington: NICHM Research and Educational Foundation, 24 July 2000, p. 2, and p. 6, Figure 4, http://www.nihcm.org/prescription.pdf. Similarly, see Henry J. Kaiser Family Foundation, *Prescription Drug Trends: A Chartbook*, Menlo Park, CA: The Foundation, July 2000, p. 65, and p. 69, Exhibit 4.4, http://www.kff.org/content/2000/3019/PharmFinal.pdf.)

4. This power will grow as drug makers merge into fewer and larger corporations. ("Mergers Could Kill Competition for Drugs, Spur Price Hikes," Associated Press, 28 January 2000.)

5. Vertical integration—including Merck's control of a major PBM—is also a concern.

6. And allegations of such anti-competitive practices as suppression of generic competitors are further signs of continued monopoly and oligopoly. (See, for example, U.S. Federal Trade Commission, "FTC Charges Drug Manufacturers with

Stifling Competition in Two Prescription Drug Markets," Press Release, 16 March 2000, http://www.ftc.gov/opa/2000/03/hoechst.htm ; John Martin, "Conspiracy to Fix Drug Prices: Drug Makers Keep Generic Drugs Off the Market," 16 March 2000, http://abcnews.go.com/onair/CloserLook/wnt_000315_CL_genericdrugs_feature.html; Ronald Rosenberg, "Drug Makers Seeks Curb on Sale of Generic Cyclosporin," *Boston Globe*, 7 April 2000; Michael F. Cannon, "Suppressing Generic Drugs Fleeces Consumers," Citizens for a Sound Economy Foundation *Issue Analysis*, No. 86, 25 February 1999; "The High Price of Drugs," ABC News, *20/20*, 23 July 1999, www.abcnews.go.com/onair/2020/transcripts/2020_990723_drugs_trans.html; and Sheryl Gay Stolberg and Jeff Gerth, "How Companies Stall Generics and Keep Themselves Healthy," *The New York Times*, 23 July *2000*, http://www.nytimes.com/library/national/science/health/072300hth-generic-drugs.html.*)*

[14] See, for example, a recent IMS finding that "37 percent of the top 16 pharma companies launched no new products in the U.S. in 2002. The figure for Europe was 44 percent." http://www.imshealth.com/ims/portal/front/articleC/0,2777,6599_40183881_43376184,00.html (accessed 24 July 2003).

[15] North America accounted for 51 percent of global pharmaceutical sales in 2002, according to IMS Health, and the U.S. accounted for about 95 percent of the North American total, with the U.S. share rising over time. http://www.imshealth.com/ims/portal/front/articleC/0,2777,6599_41527077_41527086,00.html For 1998, see IMS Health, *The Pharmaceutical Market World Review, 1997,* cited in www.ims-global.com//insight/world_in_brief/yearly.year.htm, downloaded 6 May 1999. For 1996, see Pharmaceutical Research and Manufacturers of America, 2000 Industry Profile, at www.phrma.org/publications/industry/profile00/figure/7.2.htm, downloaded 2 June 2000.

[16] Vanessa Fuhrmans and Gautam Naik, "In Europe, Drug Makers Fights Against Mandatory Price Cuts," *Wall Street Journal*, 7 June 2002 mention a figure of at least 60 percent.