

Testimony by

Stephen Moore

Senior Fellow in Economics at the Cato Institute

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On

The Economics of the Pharmaceutical Industry

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Thank you Chairman Burton for the opportunity to testify on the pharmaceutical industry in the United States. In keeping with the Truth in Testimony law, I wish to declare that neither the Cato Institute nor I receive any government funds, nor are we seeking any.

Why is it that when it comes to medical care in this country, policy makers in Washington almost always completely abandon sound economic principles that we know work to create wealth and improved services in every other sector of the economy? What exactly is it about the health care industry that causes normally level headed thinkers to devise crackpot solutions to the crises that it invariably turns out, government itself created?

Think about it for a moment. In every other sector of the economy we understand basic economic realities that have fostered our wonderfully prosperous society. We understand that free market mechanisms work better than government command and control solutions. We understand that maximizing consumer choice and competition creates better services and drives down costs. We understand that wage and price controls never produce desired results and create shortages.

What is especially disheartening is that we continue to devise dysfunctional legislative policies that hinder an industry that has—despite government interference—been the greatest saver of life in the history of civilization. Yes, of course, much of the progress in medicine over the past fifty years has been a result of public health measures and government investment in drugs and vaccines through agencies like the National Institute of Health. But we must also recognize that most of the progress in medical breakthroughs have been a result of private investment and the capitalistic entrepreneurial spirit which is in the noble pursuit of progress and profits. (I hope all of this does not seem to be patronizing or simplistic, but there are many policy makers in Washington who actually think that profit is a bad thing when it comes to medicine and that seniors should not have to pay the market price for the drugs they want and benefit from.)

Here's one recent example of the supremacy of our private biotechnology industry. The race to map, decode, and sequence the 100,000 genes in the human body (the human genome project) was won by a private bio-tech firm, Celera Genomics Group, despite the fact that the government supplied billions of dollars to the NIH for this purpose. This would be like a private space industry company getting a manned rocket to the moon before NASA.

It is no accident that virtually all of the breakthrough medicines and vaccines of the past two decades have come not primarily from government investment, but from private biotechnology firms that are financed through risk capital funding. This is an industry with some 1,200 companies and some 100,000 workers. U.S. firms have won the race against foreign firms in almost every one of the top 20 breakthrough new wonder drugs of the past fifteen years.

Let me repeat again the truly preposterous claim that is made over and over again that the U.S. drug industry is not just one of America's most profitable industries, but that it is too profitable. But how can this be a problem? It is profitable precisely because it makes products that people want—in some cases want desperately. Its inventions are arguably the most valuable to society. We would only have a serious problem if the situation were reversed: that the drug industry has no profits.

Now I should note here that I get no money from the drug industry, and that the Cato Institute, gets some, but not a lot. I am a huge fan of this industry simply because I benefit from its products. We all do. In fact, let's reflect for a moment on the last century of biomedical progress: in 1900 the death rate from infectious diseases was 700 per 100,000 Americans. Today, the death rate from infectious diseases is 50 per 100,000. We have been so spoiled by the amazing life saving inventions of the bio-medical industry that we don't even think about the diseases anymore that just a century ago killed millions upon millions of Americans. Back then the leading cause of death were pneumonia, influenza, tuberculosis, bronchitis, and other awful diseases like small pox, whooping cough, and polio.

More recently, consider the progress that the medical industry has made in the two leading killers today: heart disease and cancer. The survival rate from cancer is now twice as high as it was in 1960. The age adjusted death rate from heart disease is now about one-third what it was as recently as 1950.

All of this is to say that the drug industry in the United States doesn't just build a better mousetrap. This is an industry that lays golden eggs. It is now developing a new generation of exciting cures and miracle treatments for dreaded killers: cancer, heart disease, Lou Gehrig's disease, alzheimers, AIDs, multiple sclerosis, arthritis, and on and on. This industry is dedicated to unlocking the biological explanation for these and scores of other diseases that cause pain, suffering, debilitation and death.

New wonder drugs, when they are first introduced on the market are almost always tremendously expensive—just like cellular phones and video recorders were when they first hit the consumer market. But who would argue that the price for new drugs is not worth paying? A recent Washington Post story relates how new arthritis treatments are literally enabling people who have been crippled by this disease to magically rise and walk away from their wheel chairs. What price would an arthritis sufferer pay for such a treatment? Perhaps everything they have. For all the wringing of hands about the expensive costs of drug treatments, the real wonder is not how costly these treatments are, but relative to their value to those who are cured or at least relieved from pain by them, how cheap they are. We should never forget the great wisdom of Emerson who said that “the first wealth is health.”

As we speak, Congress is debating a comprehensive prescription drug benefit for seniors. My advice is stop and make a long reflection on the implications of what you are doing. We ought to be very careful—no, Congress ought to have close to 100%

certainty--that any policy changes we make that impact the drug industry, nurture it, rather than interfere with its life saving potential.

Herein lies the tradeoff that Congress seems to want to make. Almost everyone understands that to give seniors all the new drugs they want at a subsidized price could well bankrupt the nation. We can't afford to give every senior every new drug, because these drugs are expensive, anymore than Uncle Sam can build a swimming pool in every American's back yard. So we are confronted with a dilemma. If we are to subsidize drug purchases for seniors, either we let taxpayers shoulder the weighty financial burden through much, much higher taxes (after all, there is no such thing as a free lunch, someone has to pay), or we pretend there is a free lunch by imposing price controls on the drug industry and take the money out of their profits.

Those are really the only two viable options given the current proposals for Medicare prescription drug benefits. Both are very bad options.

If we demand that taxpayers shoulder the cost, we are creating a fiscal blackhole that future generations may never find a way out of. We should recognize a few fiscal realities about the prescription drug benefit plan:

1. The history of Medicare is that the predicted costs always far exceed the predicted costs. When Medicare was launched in 1965 the program was expected to cost \$15 billion in 1992. Instead it cost \$90 billion. The program was six times more expensive than anticipated. Same with Medicaid. And the same would almost certainly true of a Medicare prescription drug benefit.
2. The unfunded liability of Medicare is \$12.9 billion and of Social Security \$11 billion. The expected unfunded liability of prescription drugs over 75 years is expected to be \$3 to \$7 billion. To put this into context. The value of all the assets of the Fortune 500 companies is less than \$5 trillion. When you are in a hole, stop digging. The prescription drug benefit will drill us further into financial bankruptcy at a time when we should be reining in entitlements—especially those for seniors. According to David Walker, the head of the U.S. General Accounting Office, “Absent changes in the Medicare and Social Security programs, sometime during the 2040s, government would do nothing but mail checks to the elderly and health care providers.”
3. The prescription drug benefit will almost certainly cause drug prices to rise absent price controls. Medicare and Medicaid were what created the stampeding inflation in health care. In the 15 years prior to Medicare and Medicaid, health costs grew at 3.4% per year. But since 1966, health care costs have run ahead at 7 percent per year and at almost twice the level of overall inflation. We can expect drug prices to rise in a similar runaway pattern if the government gets in that business too.
4. As life expectancy rises, the cost of drug benefits to seniors will grow very rapidly as we pay to keep Americans alive in their last years of life. In just the next eight years the Health Care Financing Administration predicts that spending on prescription drugs will rise from \$100 billion today to \$250 billion in 2009.

Can the next generation of Americans afford the tax burden that would be required to pay for these new prescription drug benefits? The National Center for Policy Analysis says that to pay for existing promised Medicare and Social Security benefits Americans will be forced to pay a payroll tax of not 15% but 25% by 2025. Add to that a prescription drug benefit and that payroll tax could easily rise to nearly 30% of the worker paycheck. We will see a tax revolt in America that would make the Boston Tea Party seem like a day at the park before our children fork over those hefty taxes.

There is a cartoon in a recent newspaper that summarizes the story well. A senior is pushing a baby carriage through a drug store check out counter and the cashier says: "That will be \$54 for your prescription." The grandfather turns to the infant in the baby buggy and says: "Pay up." Let us not mince words. What we have here under consideration is simply a very cynical version of fiscal child abuse.

Congress should reject it.

But this brings us to the alternative form of paying for prescription drug benefits. Take it out of the hide of the industry. This is the most dangerous and unwise course of action available—and yet a course that Congress is very likely to travel.

When government intervenes in an industry as it would do on a massive scale with a new prescription drug benefit, it almost in all cases correspondingly enacted new regulations and controls of that sector of the economy. The only option that Congress would have to constrain costs of pharmaceutical drugs if the new Medicare drug plan is enacted, would be to impose controls on the prices that companies can charge. The government would soon become the single payer for drugs, which gives the Health care Finance Administration virtual unlimited monopsony power.

The temptation to limit prices for profitable drug companies could be politically irresistible. This is especially true given the overcharged rhetoric in Washington attacking drug companies for what Senator Hillary Clinton of New York has called an industry that charges "excessive profits at the hands of our seniors." Moreover, almost all other countries impose price controls on U.S. drugs, so that the price in Canada for prescription drugs is often less than half what is charged in the domestic market.

Why not impose similar controls here and save the government and consumers money? The answer is that most of the rest of the world has become a free rider on the backs of the drug industry. That foreign countries impose price controls and limits drug company profits lowers drug research and development incentives. These country's behavior thus makes sick people sicker in the long run by depriving them of new wonder drugs that would be brought to market earlier in the absence of price controls.

If the U.S. were to follow suit, the results for our health care system could be catastrophic. The U.S. as by far the largest market for new drugs, now shoulders the burden of providing fair profits for the industry. If the U.S. were to impose price controls

as Canada does, we would see a marked reduction and delay in the introduction of new drugs. There is no getting around this political reality.

For those Americans who actually suffer from debilitating diseases, the harm to society of delaying even for a few years new drug patents for heart disease, cancer, and the like is substantially greater than the short term benefit of lower prices. Moreover, in the long term, miracle drugs are the cheapest way to treat disease, so that price controls probably lose money for the government in the long term.

The bottom line is this: Congress needs to keep our drug industry innovative, profitable, and competitive to the point of being globally dominant. Any step that Congress takes to weaken this industry not only impairs one of America's genuinely competitive cutting edge industries—one that reduces our balance of trade deficit by billions of dollars and employs hundreds of thousands of high paid American workers—but also retards the basic health of this and future generations of Americans.

I would end by quoting from a Washington Post new story from June 24<sup>th</sup>, which underscores the continuing dynamism and contributions of the bio-medical industry:

“Last October a researcher named Patrick Iversen, who works at a bio-tech firm in Corvallis, Oregon, pulled genetic information about a virus off the internet and started designing a drug to attack it. He tapped into computers in Bethesda to be sure his drug wouldn't be likely to cause side effects. Satisfied, a week later he had developed some vials of a white powder.”

“If all goes according to plan, a doctor nurse will draw some of that drug into a needle later this year, perhaps in a hospital in mosquito plagued Cleveland, Ohio, and inject it into a person with West Nile Fever. The West Nile Virus drug has been developed with the help because he relied on something called antisense technology, which is the specialty of his company, AVI BioPharma Inc, a money losing biotechnology firm in Portland.”

Competing drug companies say they are finally close to making antisense drugs work. If they are right, the blistering pace of Iversen's West Niles drug might be a harbinger of the future. In the rosiest scenario of this long-range future, antisense will be like the medical ward aboard the Starship Enterprise, the space vessel from “Star Trek,” where the doctor isolates the dread germ that's turning the crew into goo, whips up a perfectly tailored antidote in minutes and sends everyone back to work.”

“It's the magic bullet,” says Alan Gewirtz, a hematologist at the University of Pennsylvania, who has worked on this technology for a decade. If the approach were to work reliably, “you could kill bacteria, you kill viruses, you could keep joints from being inflamed, eyesight from growing dim, blood vessels from getting too thick and closing off.”

These are the golden eggs that I mentioned earlier in my testimony, that are laid by the bio-tech industry. It is the exciting future of the bio-technology industry that is within our grasp. For the sake of our children and our children's children, we should race to get there and we should be willing to pay almost any price to do so. If the U.S. pharmaceutical industry makes tens or even hundreds of billions of dollars getting us to this near-disease free future, all the better.