



FACTS & OPINIONS

On Public Interest Issues

Quotes

There's a culture in Washington. The mentality is "Don't just stand there, spend something."

—Rep. Pat Toomey

An unlimited power to tax involves, necessarily, a power to destroy; because there is a limit beyond which no institution and no property can bear taxation.

—John Marshall

Whenever a man has cast a longing eye on [political offices], a rottenness begins in his conduct.

—Thomas Jefferson

In America the young are always ready to give to those who are older than themselves the full benefits of their inexperience.

—Oscar Wilde

Prescription Drug Prices and Profits

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

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Dr. Don Racheter

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What's New at PII?

Amy K. Frantz

In December, Research Analysts David Hogberg and Amy K. Frantz released a new Policy Study, *Iowa's State Budget: Fiscal Year 2004 Update*. This study updates and expands on a similar study released in 2002.

Iowa's budget crisis continues, and overspending in previous fiscal years is one of the main causes. In the past eight fiscal years, Iowa's 99% spending limit was exceeded four times, for a total of \$644 million in excess spending. This study highlights reforms the state should adopt to prevent future budget crises. To prevent spending over the 99% limit, surplus revenue should be returned to Iowa taxpayers in the form of rebate checks. Iowa also needs a Constitutional Amendment to limit state spending growth to the growth in inflation and population. Such an Amendment would provide for reasonable spending increases,

while preventing the overspending that leads to a budget crunch.

In January, Research Analyst Amy K. Frantz's Policy Study, *Township Government in Iowa*, was published. This study looks at the current duties of townships, their tax levy authority, and the amount of property tax revenue being held in reserve by township governments. The study recommends the consideration of a limit on the amount township governments may hold in reserve, and whether the township form of government itself has outlived its need to survive.

Both of these Policy Studies are available on Public Interest Institute's website at www.limitedgovernment.org or by contacting the Institute.

Research Analyst David Hogberg attended two national conferences in December. State Policy Network hosted a gathering of state think tanks in *continued on page 8*

Check out our feature — **Question of the Quarter** — on page 7. We want to know your thoughts about the issues!

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Prescription Drug Prices and Profits

Dr. Merrill Matthews Jr.

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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.

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.

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• 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.

Dr. Merrill Matthews Jr. is a visiting scholar at the Insitute for Policy Innovation. Reprinted with permission from IPI. For more information, contact IPI at 250 South Stemmons, Suite 215, Lewisville, TX 75607, call (972) 874-5139, or visit its Website at www.ipi.org.

For more on prescription drugs, see Facts and Opinions "Prescription Drug Advertising: Problem or Solution?" November 2003.

Visit Public Interest Institute's web page at www.limitedgovernment.org

Government Schemes Cost More Than Promised

Chris Edwards

In 1985 government officials claimed that Boston's "Big Dig" highway project would cost \$2.6 billion and be completed by 1998. The cost ballooned to \$14.6 billion and the project is still not finished. In 1988 Medicare's new home health care benefit was projected to cost \$4 billion by 1993; the actual 1993 cost was \$10 billion. Congress is now considering a prescription drug bill with a \$400 billion price tag. If enacted, the actual cost will almost certainly be much higher.

Large cost overruns are commonplace in government construction projects, procurement, and entitlement programs. Politicians and officials routinely deceive taxpayers by low-balling cost estimates to win initial spending approval. Then, when programs go over budget and do not work as promised, politicians place the blame on particular management blunders by the bureaucracy and private contractors. But the evidence indicates that cost overruns and program failure are not isolated errors; they are systematic and widespread in the federal government.

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 Automobiles**

Federally funded projects often turn into debacles plagued by large cost overruns, as illustrated by a wide range of examples in Table 1. For example, Boston's Central Artery project, the Big Dig, has been grossly mismanaged, as described by a recent *Boston Globe* investigation. The state government bailed out bungling Big Dig contractors 3,200 times instead of demanding accountability. Contractors were essentially rewarded for delays and overruns with added cash and guaranteed profits. The project's estimated total cost rose from \$2.6 billion in 1985 to \$14.6 billion today.

In the 1980s Denver's mayor Federico Pena sold the public on a new international airport on the basis of bad cost estimates. The public agreed to a \$1.7 billion airport in a 1989 referendum, but the cost mushroomed to \$4.8 billion by the time the airport was opened in 1995.

In 1994 Virginia officials claimed that the Springfield interchange or "mixing bowl" project would cost \$241 million. The cost has now soared to \$676 million. On the other side of the Potomac, there are cost overruns at the \$300 million Capitol Hill Visitors Center, and the cost of the Kennedy Center parking lot has jumped to \$88 million from the original 1998 estimate of \$28 million. High above the Potomac, the cost of NASA's Space

Station has skyrocketed from \$17 billion in 1995 to \$30 billion today.

These are not isolated cases of bad management. Reports by the Government Accounting Office make it clear that overspending permeates federal budgeting, as it does in Pentagon procurement and Department of Energy contracting (see Table 1). DOE contracting was put on GAO's watch list for waste, fraud, and abuse more than a decade ago. But a recent GAO review found that little had changed. In 2001, 38 percent of projects examined

had more than doubled in cost, and the National Research Council concluded that DOE is "not in control" of many of its contracts. Billions of dollars have been wasted on DOE projects that were terminated, such as the \$2 billion spent on the Texas Superconducting Super Collider.

A study last year by Danish economists looked at 258 government transportation projects in the United States and abroad with a combined value of \$90 billion. They found that cost overruns are routine and stem

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Table 1: Selected Government Cost Overruns		
Project	Estimated Cost and Date of Estimate	
	Original	Latest or Actual
Transportation		
Boston "Big Dig"	\$ 2.6b (1985)	\$14.6b (2002)
Denver International Airport	\$1.7b (1989)	\$4.8b (1995)
Virginia "Mixing Bowl"	\$241m (1994)	\$676m (2003)
Seattle Light Rail System	\$1.7b (1996)	\$2.6b (2000)
Kennedy Center Parking Lot	\$28m (1998)	\$99m (2003)
Energy		
Yucca Mountain radioactive waste	\$6.3b (1992)	\$8.4b (2001)
Hanford Nuclear Fuel Site	\$715m (1995)	\$1.6 b (2001)
Idaho Falls Nuclear Fuels Site	\$124m (1998)	\$273m (2001)
National Ignition Laser facility	\$2.1b (1995)	\$3.3b (2002)
Weldon Springs remedial action	\$358m (1989)	\$905m (2001)
Defence (per unit)		
F/A-22 Raptor Fighter	\$ 89m (1992)	\$248m (2002)
V-22 Osprey aircraft	\$23m (1987)	\$90m (2001)
RAH-66 Comanche helicopter	\$31m (2000)	\$52m (2002)
CH-47F Cargo helicopter	\$8m (1998)	\$18m (2002)
SBIRS satellite system	\$432m (1998)	\$1.6b (2002)
Patriot Advance Missile	\$4m (1995)	\$10m (2002)
EX-171 guided munition	\$39,000 (1997)	\$147,000 (2002)
Medicaid		
Special Hospital Subsidy	\$100m (1987)	\$11b (1992)
Medicare		
Part A (HI), Cost in 1990	\$9b (1965)	\$67b (1990)
Home care benefits, cost in 1993	\$4b (1988)	\$10b (1993)
Other		
1996 farm law (over Seven Years)	\$47b (1996)	\$118b (2002)
International Space Station	\$17b (1995)	\$30b (2002)

Government Schemes Cost More Than Promised

Chris Edwards

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from government deceit, not honest errors. Nine of 10 projects examined had cost overruns, with an average overrun of 28 percent. The study concluded that lying, or intentional deception, by public officials was the source of the problem: “Project promoters routinely ignore, hide, or otherwise leave out important project costs and risks in order to make total costs appear low.” Politicians use “salami tactics” whereby costs are only revealed to taxpayers one slice at a time in the hope that the project is too far along when true costs are revealed to turn back.

Salami tactics are just one problem that makes federal funding of state, local, and private activities wasteful. Another problem is that the states compete with each other to secure federal dollars, and thus they are prone to exaggerate benefits and minimize costs of projects. When cost overruns occur, state officials seek to cover up poor contractor performance in order to conceal their own bad oversight, as occurred with the Big Dig. In addition, the federal government does not ensure efficient use of funds sent to states. For example, the GAO found that half of the federally funded highway projects

it examined recently had cost overruns of greater than 25 percent.

Entitlement Cost Overruns Are Endemic

Federal “entitlement” programs, such as Medicare and Medicaid, grow unconstrained and far beyond promised limits. Politicians low-ball initial costs to gain approval by putting supposed benefit limits in legislation. But cost limits either do not work, are evaded, or are later repealed. When costs soar and programs do not work, politicians hold hearings to cast blame elsewhere, such as on drug firms or hospitals. But that is just a charade — Congress should know by now that high costs and poor performance are to be expected when central planning, as in Medicare, is substituted for private competitive markets.

To enact Medicare in the 1960s, public officials deceived the public in numerous ways, such as promising that the payroll tax rate would not rise higher than 1 percent. When Medicare Part A was enacted in 1965, costs were projected to rise to \$9 billion by 1990, but actual costs reached \$67 billion by 1990. Or consider that when the Medicaid special hospitals subsidy was added in 1987 annual costs were projected to be \$100 million. By 1992 costs had risen to \$11 billion annually.

Today, most analysts are projecting that the \$400 billion prescription drug plan will end up costing far more than is being claimed. Important drug bill

supporters are already saying that they plan to push for further drug spending after any initial bill is passed.

Return Economic Activities to the Private Sector

Governments are wasteful users of resources because they tend to replace competition with monopoly and market pricing with bureaucratic regulations. Also, since public officials do not risk their own personal funds, they are more likely to support unsound schemes and be less interested in keeping programs on budget. As a consequence, we would be better off if Congress scaled back entitlement programs, privatized infrastructure such as airports and energy projects, and let entrepreneurs put up their own capital for risky pursuits such as space exploration.

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Should Congress Stop Funding PBS and NPR?

John Berthoud

For years, the government-owned Corporation for Public Broadcasting (CPB) and its affiliates, National Public Radio (NPR) and the Public Broadcasting Service (PBS), have been the recipients of large public handouts.

Tax dollars from wealthy, middle-income, and lower-income Americans have gone to subsidize programming whose audience is disproportionately upper-income.

The time has come to end the gravy train of taxpayer dollars.

When CPB was created in 1967 — before the Internet, before satellite television, before VCRs or DVDs, before cable TV with hundreds of channels — a stronger case could be made that there was a public benefit to subsidize other voices and programming. Now, with the media explosion of the past quarter century, there is little justification left for public subsidies.

Why continue to underwrite Julia Child and Emeril Lagasse — especially when viewers can watch the Food Network, where the latter often appears?

Why subsidize history programming on PBS when viewers have the History Channel or can rent history documentaries

at their local video store?

Along with all the stations on free radio, listeners can tune in over the Internet to hundreds of stations all over the world. And for less than \$10 a month, listeners can receive the 100 channels of XM Radio in their cars and homes.

Further, while PBS and NPR have perhaps made some improvement in recent years, they still often reveal a substantial leftward bias.

In discussing NPR, Richard Rahn observes that the public subsidies and leftward tilt are related events: “NPR will never be fair and balanced. Because it depends on government, it will always support government spending over the rights and needs of taxpayers. It attracts a staff that is hostile to the private sector, and that loves government.”

PBS and NPR have proven quite capable of generating healthy cash flows. Successful PBS children’s programming has

produced tremendous revenues.

For example, the show “Dragon Tales” — which had received over \$4 million in federal subsidies — now brings in buckets of cash through sales of books, DVDs, CDs, and other items.

But beyond great success in marketing, PBS and NPR get generous support “from viewers like you.” Most recently, Joan Kroc, the widow of McDonald’s founder Ray Kroc, gave the staggering sum of \$200 million to NPR. Surely, with this massive new amount in hand, NPR is more than capable of completely weaning itself from taxpayer dollars.

John Berthoud is President of the National Taxpayers Union. Reprinted with permission from NTU. For more information, contact NTU at 108 North Alfred St., Alexandria, VA. 22314, call (703) 683-5700, or visit its Website at www.ntu.org.

Facts & Opinions Question of the Quarter:

Should Congress Stop Funding the Corporation for Public Broadcasting?

Send your thoughts on this issue to us at public.interest.institute@limitedgovernment.org.

We will publish some of your ideas in the next issue of *Facts & Opinions* in May 2004 and on our Website at www.limitedgovernment.org.

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What's New at PII?

**Amy K. Frantz
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Washington, D.C., providing briefings on the Medicare bill, and pharmaceutical and telecom issues.

American Legislative Exchange Council (ALEC) hosted its annual States and Nation Policy Summit, to help State Legislators prepare for their upcoming sessions. David Hogberg was part of a panel of public policy experts on the topic of fiscal and state budget issues.

On the local level, Research Analyst Amy K. Frantz continues to serve as a volunteer member of the Mt. Pleasant Area Development Commission's Government Affairs Committee.

Focus on Iowa Wesleyan College

Iowa Wesleyan College president, Dr. William N. Johnston successfully raised funds for the renovation of the College Chapel by riding his bike. When Johnston agreed to participate in the Des Moines Register's Annual Great Bike Ride Across Iowa, the Board of Trustees offered to donate funds if he could successfully complete the 450 mile trek. Others joined in the challenge, and Johnston completed the challenge, netting \$40,000 for the chapel.

Wesleyan is also having success in boosting its enrollment for academic year 2003-04. An increase of 45 new full-time

students, combined with part time and extended learning students, account for a nine percent increase, the highest in two years. A stepped-up recruiting effort and a revamped financial aid package are credited with the increase.

Finally, Wesleyan appointed some new faculty members last semester. Dr. Donald Wick has been named associate professor of biology. Dr. Wick received his Ph.D. from the University of Iowa. Dr. Thomas Vallambroso is associate professor of chemistry. Dr. Vallambroso earned his Ph.D. from Pennsylvania State University. Finally, Vinu George is associate professor of computer science. George has a master's degree from Mississippi State and is currently working on his Ph.D.