

**Bigger Than the Social Security Crisis:
Wasteful Spending on Prescription Drugs**

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Executive Summary

President Bush started a national debate on the future of Social Security when he announced his plan for private accounts shortly after the November election. In order to promote his plan, he has argued that Social Security faces a serious long-term funding gap.

It is easy to show that the projected funding gap for Social Security is relatively minor. The Social Security trustees estimate that the gap over the program's 75-year planning period is equal to 0.6 percent of GDP over this period. The non-partisan Congressional Budget Office (CBO) estimates this gap at 0.4 percent of GDP. By comparison, the increase in annual defense spending since 2000 has been equal to 1.0 percent of GDP, more than 1.5 times the size of the shortfall projected by the Social Security trustees and 2.5 times as large as the shortfall projected by CBO.

Given the size of the projected Social Security shortfall it is reasonable to argue that attention should be focused on bigger problems. One glaring example is the soaring price of prescription drugs, which is imposing huge costs on both the private and public sectors. This paper examines the relationship between the potential savings from creating a free market in prescription drugs and the size of the Social Security shortfall.

Specifically, it calculates the savings that the federal government could accrue in Medicare if drug research was publicly financed and then the resulting patents were placed in the public domain, as proposed in the Free Market Drug Act (FMDA). This would allow prescription drugs to be sold in a competitive market, like other products. By eliminating government imposed patent monopolies, drug prices would decline by approximately 70 percent.

This paper calculates that the savings to the federal government from having drugs sold in a competitive market could reach \$110 billion annually by 2014. By the end of the period (in 2080) the annual savings would be equal to 1.2 percent of GDP. The cumulative savings over the 75-year planning horizon would be \$3.3 trillion (in discounted 2005 dollars); this is slightly larger than the \$3.2 trillion Social Security shortfall projected by the CBO. In other words, if the federal government's savings on prescription drugs from the FMDA were attributed to the Social Security trust fund, it would be more than enough to make Social Security fully solvent over its 75-year planning period.

The enormous potential savings from developing a free market in prescription drugs should be a powerful argument for moving in this direction in any case, but the possibility of using the savings to eliminate the projected Social Security shortfall could make the policy even more attractive. Of course, the savings to the private sector from having drugs sold in a free market would be even larger than the savings to the federal government.

However, the most important benefit is that the FMDA would eliminate the incentives that government patent monopolies create to conceal or misrepresent research findings, as was recently exposed with drugs like Vioxx and Celebrex. If research is no longer financed by government patent monopolies, the perverse incentives they create will be eliminated. This will lead to better health care, in addition to much lower drug prices.

Introduction

Since shortly after his re-election President Bush has vigorously argued that the Social Security system desperately needs to be fixed. Many other politicians and political commentators have echoed this view.

The official projections for the program don't support the claim that any urgent action is needed. The Social Security trustees report shows that the program will be fully solvent for the next 36 years with no changes whatsoever. It also shows that the tax increase that would be needed to pay all benefits for the entire 75-year planning horizon is smaller than the size of the tax increase implemented in each of the decades from the 1940s through the 1980s.²

The non-partisan Congressional Budget Office (CBO) projects that the program would be fully solvent for 47 years with no changes whatsoever. It estimates that the program could be made fully solvent for its 75-year planning period with an amount of revenue that is only 40 percent as large as the increase in annual defense spending since 2000. To use another comparison, CBO estimates that the size of the Social Security shortfall is approximately 20 percent of the size of the tax cuts that President Bush has implemented since he took office. The projections of both the Social Security trustees and the CBO show that Social Security can be kept fully solvent for the indefinite future without any major changes and without posing any threat to the living standards of future workers or the economy.

Since the Social Security shortfall is relatively small, the country faces many problems that have considerably more impact on people's lives and living standards. At the top of this list is the soaring cost of health care in general and of prescription drugs in particular. It is easy to show that rising health care costs pose a much greater threat to future living standards and to the federal budget. The projected increase in health care costs over the next decade, in excess of GDP growth, will have 7 times as much impact on living standards as the tax increase that the CBO estimates would be needed to close the Social Security funding gap.³ Due to rapid increases in health care costs, Medicare is projected to cost more than Social Security in less than 25 years.⁴ Medicare is projected to cost nearly twice as much as Social Security by the end of the planning period in 2080.

The largest single cause of rising health care costs is the rising cost of prescription drugs. Data from the Center for Medicare and Medicaid Services (CMS) show that prescription drug costs have been rising at a nominal rate of 13.3 percent annually over the last

² Four of the six Social Security trustees are political appointees of President Bush.

³ See D. Baker and D. Rosnick, 2005, "The Burden of Social Security Taxes and the Burden of Excess Health Care Cost Growth," Center for Economic and Policy Research
[\[http://www.cepr.net/publications/ss_hc_2005_03_24.pdf\]](http://www.cepr.net/publications/ss_hc_2005_03_24.pdf).

⁴ Cost estimates can be found in the supplementary data (scenario 2) from the Congressional Budget Office's The Long-Term Budget Outlook, December, 2003
[\[http://www.cbo.gov/showdoc.cfm?index=4916&sequence=0\]](http://www.cbo.gov/showdoc.cfm?index=4916&sequence=0). Data for years after 2050 can be found in *A 125-Year Picture of the Federal Government's Share of the Economy, 1950 to 2075*, CBO 2002.

decade.⁵ Projections from CMS show that prescription drug costs will rise at a 10.0 percent annual rate over the next decade.

Until recently, the private sector was responsible for the vast majority of prescription drug spending. However, this will change beginning in 2006 with start of the Medicare prescription drug benefit. This benefit will result in the government paying more than half of the cost of prescription drugs for those over age 65 and nearly 45 percent of total prescription drug costs. As a result, any measures that substantially reduce the price of prescription drugs will lead to large savings for the government.

It is not difficult to find ways to reduce drug prices, since the reason that prescription drugs are expensive is that the government grants pharmaceutical companies patent monopolies. Drugs are almost invariably cheap to manufacture. Most drugs could be profitably sold at \$20 or \$30 per prescription, if there were no patent monopolies. However, government patent monopolies allow companies to charge prices far above free market levels. Since the patented drugs are often essential for a person's life or health, drug companies are able to set prices that can be several thousand percent above the free market level.

Of course, patent monopolies do serve an important purpose. They provide incentives to innovate and develop new drugs. However, there are almost certainly far more efficient ways to finance research. Patent monopolies raise the price of prescription drugs by \$4 to \$5 for every dollar that the industry spends on research.⁶ The rest of this money goes to marketing and industry profits.⁷

Furthermore, patent monopolies distort research incentives.⁸ First and foremost they encourage copycat research. Drug companies spend much of their money researching drugs that essentially serve the same purpose as existing drugs. These copycat drugs allow companies to get around their competitors' patents and earn a portion of their patent rents. While this sort of competition helps bring down prices, if the government didn't grant patent monopolies in the first place there would be little point to researching most copycat drugs. According to the Food and Drug Administration, approximately 70 percent of new drugs fall into this copycat category.

The patent system also provides enormous incentives for companies to conceal unfavorable research findings and even to misrepresent results. There has been an endless stream of scandals surrounding drugs such as Vioxx and Celebrex where companies have

⁵ Data on prescription drug spending can be found in CMS, National Health Expenditures, Table 2 and Table 11.

⁶ At current spending levels, patent monopolies inflate drug prices by approximately \$140 billion a year over the free market level. The industry claims to do approximately \$25 billion of research.

⁷ See P. Stein and E. Valery, 2004. "Competition: Antidote To The High Price Of Prescription Drugs," *Health Affairs*, V23, # 4, 151-158.

⁸ See Baker 2004, ("Financing Drug Research: What Are the Issues?" Center for Economic and Policy Research [http://www.cepr.net/publications/patents_what_are_the_issues.htm]) for a fuller discussion of the distortions created by the system of drug patents and the relative costs and benefits of various alternative mechanisms for financing prescription drug research

sought to conceal or misrepresent research findings. These efforts sometimes include payoffs to experts to gain their support and fees to lobbyists and politicians to ensure favorable regulatory rulings.

Economic theory predicts that when the government intervenes to impose a monopoly, as it does with drug patents, it creates economic distortions and perverse incentives. When the monopoly profits are very large, as is the case with prescription drugs, the resulting distortions will be proportionately large.

The Free Market Drug Act – One Way to Reduce Prescription Drug Prices

One way to substantially reduce prescription drug prices is simply to get rid of the government patent monopoly. This is exactly what the Free Market Drug Act (FMDA) was intended to accomplish.⁹ This bill, which was introduced in the last session of Congress, would expand public funding for biomedical research enough to replace the patent supported research being conducted by the pharmaceutical industry.

At present, the federal government spends approximately \$30 billion a year on biomedical research primarily through funding the National Institutes of Health. The FMDA would increase this spending by approximately \$20 billion, with the additional money explicitly allocated towards the development of new drugs. All the findings from this publicly supported research, and all ensuing patents, would be placed in the public domain. This means that all the new drugs developed with this funding could be sold as generics from the day they are approved. While the pharmaceutical industry would be able to continue to do its own research and secure patents, it is unlikely that it will be willing to invest the sums required to develop new drugs when it is likely that they will have to compete with generic alternatives that will often be as good or better. This means that in a relatively short period of time, nearly all drugs will be available at competitive market prices.

The potential savings to the country and the government from having drugs sold at free market prices are enormous. The CMS estimates that the country will spend \$521 billion on drugs in 2014. This figure could fall to approximately \$160 billion, if drugs were sold in a competitive market. The savings accruing to the federal government alone would be approximately \$140 billion a year by 2014, several times more than the additional research spending needed to replace the patent supported research by the pharmaceutical industry.¹⁰

⁹ The Free Market Drug Act was introduced by Representative Dennis Kucinich. A summary can be found on his website [<http://www.house.gov/kucinich/issues/freemarketdrugact.htm>].

¹⁰ The CMS projects federal spending on prescription drugs in 2014 as \$199.5 billion, the estimate of \$160 billion in savings assumes that drug prices are reduced by 70 percent as a result of being sold in a competitive market.

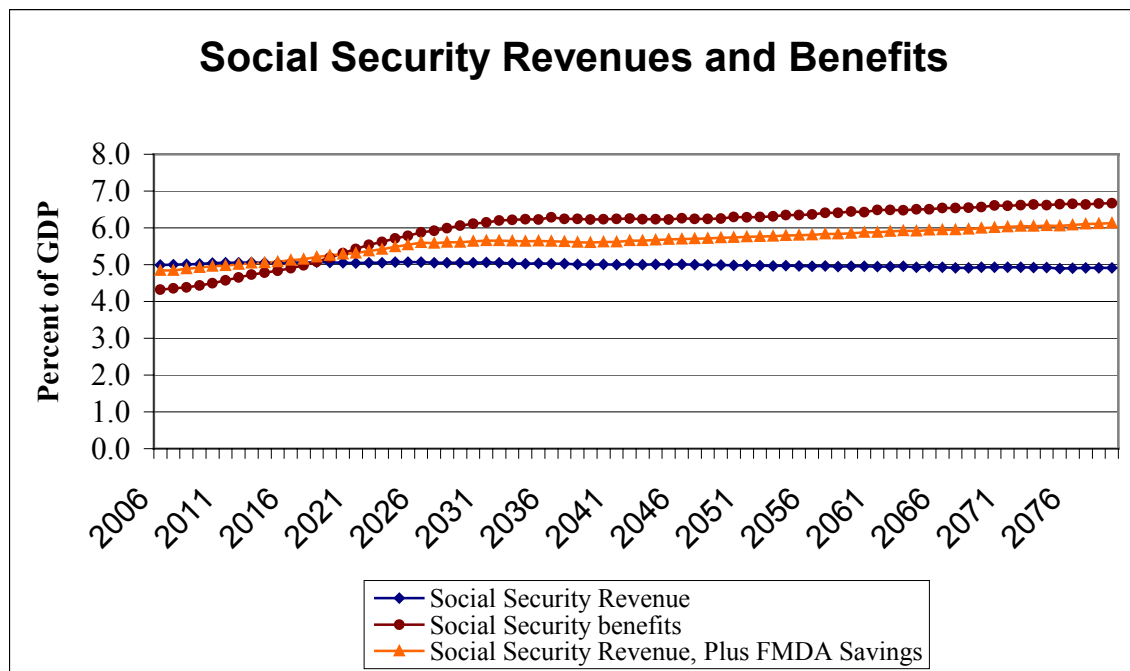
The Free Market Drug Act and Social Security

Because the savings on drugs are large while the projected gap in financing Social Security is relatively small, the potential savings to the federal government alone from implementing the FMDA would be large enough to fully eliminate the projected shortfall over Social Security's 75-year planning horizon. The savings accruing to the private sector and state governments from the FMDA would be even larger.

According to the CBO, the discounted value of the projected Social Security shortfall is approximately \$3.2 trillion over the programs 75-year planning period. This is slightly less than the \$3.3 trillion projected savings to the federal government from the FMDA over this period.¹¹ This means that if the federal government's savings from the FMDA were committed to supporting the Social Security system, then the program would be fully solvent throughout its 75-year planning period.

Figure 1 shows the Congressional Budget Office's projections for annual Social Security tax revenue and spending as a percent of GDP. It also shows projected revenue, if the federal government's savings from the FMDA were credited to the program.

Figure 1



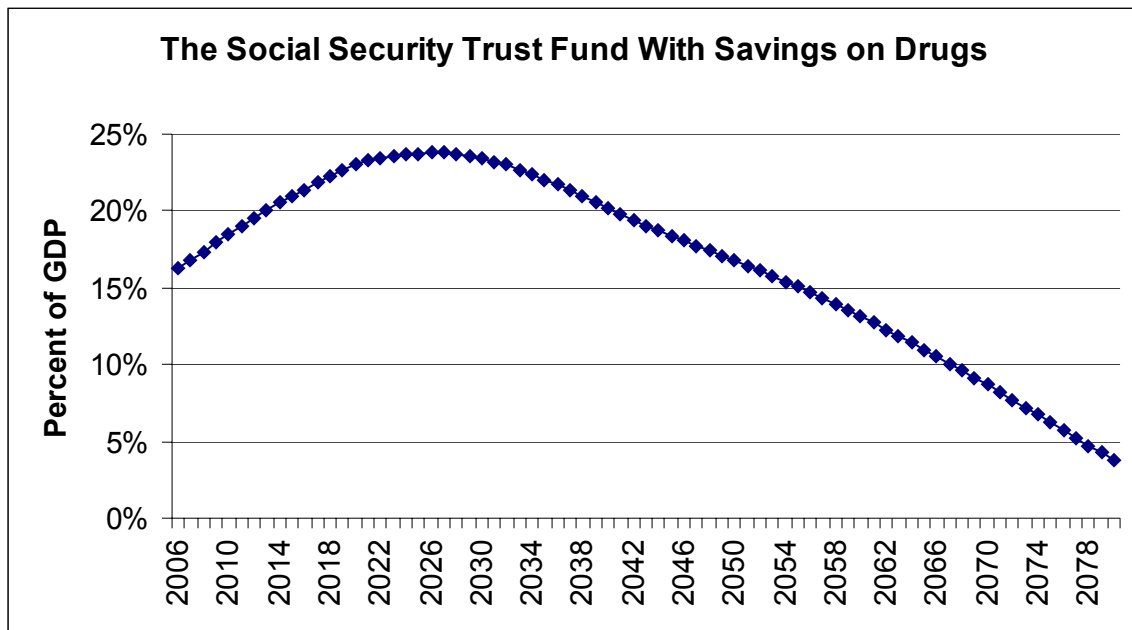
Source: CBO and author's calculations, see appendix.

¹¹ This calculation is explained in the appendix.

While projected spending does still cross projected revenue, this does not occur until 2021, at which point the trust fund would have accumulated \$5.9 trillion (in 2005 dollars). Furthermore, the annual gap between projected benefits and revenue is much lower than in the baseline case, with the FMDA contributing savings that reach more than 1.0 percent of GDP annually by the end of the 75-year planning period. The additional savings from the FMDA are sufficient to keep Social Security fully solvent over its 75-year planning period.

Figure 2 shows the projected size of the trust fund over Social Security’s 75-year planning horizon if the federal government’s savings from the FMDA are attributed to Social Security. The figure shows that even at the end of the planning period in 2080, the trust fund would still have assets equal to approximately 4 percent of GDP, which is equivalent to \$480 billion at present. In other words, this change alone would be more than sufficient to maintain the Social Security system’s solvency throughout its 75-year planning horizon.

Figure 2



Source: CBO and author’s calculations, see appendix.

The Benefits of Competitive Pricing for Prescription Drugs

While the federal government’s savings from implementing the FMDA is likely to be large enough to fully eliminate the projected shortfall in the Social Security program, this would not be the main reason for promoting a free market in prescription drugs. As was noted earlier the combined savings to the private sector and state governments would actually be larger than the savings to the federal government.

Perhaps even more importantly, the elimination of government patent monopolies would remove most of the incentive to conceal or misrepresent research findings. There are millions of people across the country who have received improper treatment for illnesses or medical conditions because pharmaceutical companies withheld or spread inaccurate information in pursuit of monopoly profits. If drugs were sold in a competitive market, like other products, most of the incentive for life- and health-endangering misrepresentations would vanish.

Given the large and growing burden that prescription drug costs pose for the country, developing more efficient alternatives to the patent system for financing drug research should be at the top of the nation's agenda. If the current debate over Social Security provides a route for addressing this fundamental national and international problem, then it will have been a very constructive debate.

Appendix

The calculations of the savings from the FMDA assume that Medicare savings on prescription drugs can be reduced by 70 percent if all drugs are sold in a competitive market, which is the intended outcome of the FMDA. The calculations assume that drugs produced through public financed research first start to have an impact on prices in 2009, with the full 70 percent price reduction not achieved until 2028. (The savings relative to baseline prices is assumed to increase at the rate of 3.5 percentage points annually.) The baseline projection for Medicare prescription drug payments is taken by subtracting the difference between the CBO projections for Medicare costs in 2003 Long-term budget projections and the 2002 projections in its *A 125-Year Picture of the Federal Government's Share of the Economy, 1950 to 2075*. For years after 2050, it is assumed that Medicare drug costs rise at the same rate, measured as a share of GDP, as they did in the decade from 2040 to 2050. This method would underestimate actual federal spending on drugs, since it excludes spending on Medicaid and also payments for current and former government employees.

It is assumed that it will take approximately \$20 billion of annual federal spending at present to replace the drug research being supported by patents. The pharmaceutical industry currently claims to be spending approximately \$25 billion a year on research. Approximately 70 percent of the drugs currently approved fall in the copycat category. This means that a large portion of this research is of little use and would not be conducted, if the patent system did not provide firms with an incentive to encroach on the monopoly profits earned by competitors. Also, approximately 10 percent of research spending is devoted to production quality. This research would be undertaken even if all drugs were sold as generics. The \$20 billion figure should be sufficient to replace approximately 90 percent of the patent supported research currently conducted by the pharmaceutical industry. The projections assume that the amount of public financing for pharmaceutical research increases by 0.1 percentage point of GDP every 20 years.

Data for Social Security spending and revenue were taken from CBO Updated Long-Term Projections for Social Security (March, 2005) [<http://www.cbo.gov/showdoc.cfm?index=6064&sequence=0>], supplemental tables. The calculations for Figure 1 and Figure 2 assume that all savings from the FMDA (as calculated above) are credited to the Social Security trust fund. They are assumed to earn the 3.3 percent real rate of interest assumed by CBO in its analysis of the Social Security program.