Democracy Dies in Darkness

Opinion

No, Big Pharma's high prices don't drive innovation

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This year, for the first time, a handful of prescription drug manufacturers will negotiate with the Centers for Medicare and Medicaid Services over how much taxpayers will pay for their costly drugs. Big pharmaceutical companies have long argued that such price negotiations will lower their profits, reducing their ability to innovate. But is that true?

Not according to an analysis we published at our think tank, the Foundation for Research on Equal Opportunity. Our research shows that the biggest drug companies largely fail to turn their enormous profits into discoveries. Instead, most innovation is taking place at small, *unprofitable* start-ups, whose drugs are largely excluded from Medicare's new price negotiation system. When it comes to pharmaceutical innovation, smaller is better.

For our analysis, we reviewed 428 recent drug approvals by the Food and Drug Administration and surveyed financial data from more than 4,000 pharmaceutical and biotech companies. We found that large companies, defined as those with more than $10 billion in annual sales, produced 86 percent of the industry's revenue but that only 36 percent of the drugs approved by the FDA. By contrast, emerging start-ups with less than $500 million in annual sales or less than $200 million in annual R&D spending produced 3 percent of the industry's revenue but discovered more than half of all newly approved drugs.

You'd think that the biggest drug companies with the biggest R&D budgets would have the most productive research labs. But it doesn't work that way.

Large companies tend to be bureaucratic, risk-averse and much more focused on increasing profits from their existing drug product lines. That's partly because their largest and most influential shareholders care more about quarterly returns than long-term success. As a result, big companies overinvest in low-quality but "safe" ideas and underinvest in better but risky ones.

By contrast, smaller companies are nimbler and can better attract top scientific talent. The most creative scientists work at start-ups where they often have more freedom. Start-ups also let them generate far more wealth through stock options rather than through modest year-end bonuses at behemoths like Eli Lilly or AstraZeneca.

If large companies' labs are so unproductive, you might ask, why are so many of the world's top-selling drugs manufactured by bigger companies? Because of the FDA's high regulatory costs. Smaller companies can't always afford to conduct the large billion-dollar clinical trials required for approval. As a result, big companies treat emerging start-ups like their farm team, buying off their best drugs, raising their prices and reaping the profits.

The good news is this is beginning to change. Emerging companies are increasingly taking their best drugs to market by themselves. In 2013, only 23 percent of successful drugs developed by emerging companies reached FDA approval under the original developer. By 2022, that share increased to 75 percent. If this trend continues, patients will benefit from a more competitive and diverse ecosystem of drug developers.

Opponents of drug-price negotiation on Wall Street and in Silicon Valley have no problem with large multinationals gobbling up smaller companies. Mergers and acquisitions, they argue, enable investors in those smaller companies to generate quicker returns, incentivizing further investment in start-ups.

But investors also make money if start-ups take their innovations all the way to market. In fact, over the long term, investors can make more money if start-ups become multibillion-dollar success stories rather than selling out at an earlier stage for lower acquisition prices. A more diverse ecosystem of successful, profitable biopharmaceutical companies will lead to more innovation, not less.

The drug negotiation provisions in the Inflation Reduction Act were designed with these considerations in mind. The law exempts from its process any drug representing more than 80 percent of a company's sales to the Medicare program, effectively excluding emerging start-ups with one FDA-approved medicine.

And more affordable medicines benefit all Americans, not just seniors in Medicare, because all taxpayers fund the program through payroll taxes.

That's why President Biden has proposed expanding Medicare price negotiations from 20 drugs a year to 50, a reasonable idea that would reduce the federal deficit and Medicare premiums. People often think the only way to make Medicare sustainable is to raise taxes or cut benefits. But reducing what Medicare must pay for the care seniors receive can also help accomplish this goal.

We can do other things to lower drug prices while protecting innovation. First, we can eliminate the Inflation Reduction Act's punitive tax for companies that refuse to negotiate with the Medicare program. In a true negotiation, manufacturers should have the right to walk away from Medicare. They rarely will, given the value of Medicare's 65-million-person market, but the right to do so will incentivize Medicare to negotiate in good faith.

Second, we can reduce red tape at the FDA and enable more drugs to reach patients after compelling midstage clinical trials. We already do this for cancer and HIV, and there's no reason we shouldn't do it for chronic diseases when scientifically appropriate.

The real barrier to innovation in drug development isn't manufacturers' ability to charge extortionate prices; it's the ever-increasing cost of navigating the FDA's approval process. In the rest of the economy, innovation drives lower prices for valuable goods and services. The pharmaceutical industry — and its regulator — should follow suit.