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Prescription Drugs and Advertising

by William L. Anderson

In the continuing debate over the prices of prescription drugs, Ellen Goodman, a Pulitzer Prize-winning columnist, believes she has found the *real* answer to why many drugs are so expensive. The culprit, she says, is advertising, and lots of it. She writes: "Pharmaceutical companies tell us that the cost [of drugs] is connected to research and development. No cost, no cure. But major drug companies, as a Families USA report shows, spend more on marketing, advertising, and administering than on R&D. Indeed, some of what they call research—Let's color that pill purple!—is what we call marketing."[1]

Goodman is hardly alone in her views. Indeed, people on all sides of the debate often say the same thing. Drug companies do cite R&D costs as a major contributor to prescription drug prices, just as oil companies cite the high cost of crude oil for high gasoline prices. In other words, according to most who participate in such debates, costs drive prices. To be more specific, these folks hold that the costs of the factors of production (or what economists call inputs) directly determine the prices of the final products that individuals consume.

Government regulators usually base pricing policies on this "cost-plus" notion of prices. For example, when the U.S. government regulated gasoline prices during the 1970s, regulators tied increases in pump prices to price increases in crude oil. Of course, those regulators also forbade gasoline retailers to raise pump prices immediately after crude prices increased, since it would take four to six weeks before the higher priced crude actually became usable gasoline. Therefore, retailers had to wait before being permitted to raise prices.

(It does not take an economic expert to know what chaos this system created. Consumers, correctly anticipating future price increases, quickly increased their demand for gasoline purchases in the present. Because retailers were not able to raise prices in the presence of demand increases, it did not take long for anxious buyers to strip current supplies, leading to the infamous "Sorry! Out of Gas" signs that began to appear at gas stations across the country.)

The notion of cost-plus pricing is hardly new. Many ancient scholars, in search of the "just price," assumed that such a price had to be based on production costs. However, as Murray Rothbard noted, by the Middle Ages many of the Scholastic writers had jettisoned that view for a utility-based interpretation of value.[2] In fact, it wasn't until the rise of the English classical economists of the eighteenth and nineteenth centuries, including Adam Smith and David Ricardo, that cost of production once again took center stage.[3]

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Had the classical view been correct, folks like Ellen Goodman and the government regulators would have been justified in believing the cost of production ought to determine prices. However, the cost-of-production theory of value has a number of inherent problems, the chief one being that it explains nothing.

If one were to employ the cost-of-production theory to explain the price of my computer, the causality might go as follows: the price comes from the cost of the factors of production that went into making the computer, including labor, raw materials, components, and the machinery (capital goods) that assembled them.

Fine enough, one might say, but from where did *those* costs come? A classical economist might answer that those costs came from the costs of the factors that produced the capital goods and raw materials. The costs of raw materials would come from the land and labor. Karl Marx reduced all production to labor in his variation of the labor theory of value. (Marx developed his theory of value from the "cost of production" theories of Adam Smith and David Ricardo. He took those theories to their logical conclusion in developing his own interpretation of value.)

The problem is that we are stuck in an endless regression. Costs begat costs, but no one seems to be able to tell from where the *original* costs of land and labor emanated. In other words, one concentrates on *effect,* but cannot locate the original *cause.* (Marx does not provide a solution either, because he does not provide a causal mechanism for labor's value. Should a worker be paid $3 or $300 an hour? Marxism cannot answer that question.)

Utility Theories of Value

A general utility theory of value seems to offer an alternative to the cost theory, but it also has severe limitations. For example, the famous diamond-water paradox came from the confusion caused by general utility valuation. Water is more important to life than diamonds. Therefore, given a general utility view, water is more valuable than diamonds, yet in most cases the cost of potable water (at least in this country) is nearly nothing, while your friendly jeweler demands big bucks for diamond jewelry. As a Marxist who teaches economics once told me, the diamond-water paradox is "proof" that capitalism has distorted the values of society.

Yet no distortion exists. As I wrote in these pages previously, "Value . . . is determined by the usefulness of the marginal available unit of the item in question, or *marginal utility*. An individual imputes value to a particular *unit* of water, not to the overall characteristics of water itself."[4]

Furthermore, as Carl Menger, the founder of the Austrian school of economics, pointed out in his 1871 classic, *Principles of Economics,* the value of factors of production ultimately depends on the value that consumers place on the final (consumption) good made from those factors. For example, before people discovered they could distill

kerosene from crude oil, crude was mainly seen as a nuisance. Before the development of kerosene, people in western Pennsylvania drilling for water who instead hit oil did not think of themselves as fortunate. Instead, they cursed their bad luck.

In other words, oil-derived products like gasoline and heating fuels do not gain their value from crude oil or from any of the processes involved in the creation, transportation, or sale of fuels. Instead, crude oil, refining, and transportation of oil products all receive their value from the value of the fuels, nylon, and other oil-derived products that consumers use.

Menger asked what would happen to the value of factors of production used for making tobacco products if everyone were to stop consuming tobacco. He noted "finished tobacco products" would lose their value. But that's not all: "A further consequence would be that the raw tobacco leaves, the machines, tools, and implants applicable exclusively to the processing of tobacco, the specialized labor services employed in the production of tobacco products, the available stocks of tobacco seeds, etc., would lose their goods-character."[5] Obviously, among the labor services losing value would be the marketing of tobacco products.

To place Menger's analysis in the context of marketing drugs, one could say that a marketing campaign for a certain new drug does not drive up the price of drugs. Instead, a company will engage in a potentially costly but wide-ranging marketing plan for the drug because people at the firm believe the new drug will be profitable. The value of the marketing plan is derived from the value that consumers place on the drug, not the other way around.

Another way to look at this issue is to do what Goodman implies should be done: eliminate most of the marketing. In her view the "cost" of drugs would be lower, which would mean they could be sold to the public for less. This is a rather naïve view of things. A firm does not employ marketing to raise its costs. Instead, it engages in marketing to inform the buying public (and especially doctors who will write prescriptions) of the drug's effectiveness. Without marketing, it would be unable to get out the necessary information to make its drug salable in the first place.

In short, commentators like Goodman—as well as those who publicly represent the drug industry—have the scenario backwards. The value of a drug is decided in the marketplace, with consumers driving the whole process. Granted, there are factors that keep drug prices high, like patents and third-party payments through insurance and government. The patents restrict the amount that will be made available, while third-party payments help keep demand at high levels.

But those facts cannot change the principle that consumer demand ultimately determines not only the value of an end product, but also the value of all of the factors of production (including marketing) that go into making it available to people. Marketing doesn't drive up the price of a drug; rather, the prospect of a drug's benefits (hence, its profitability) makes its marketing valuable. □

1. Ellen Goodman, "Prescription Drug Ads Drive Up Costs," *Greenville* (S.C.) *News*, July 15, 2001, p. G3.

2. Murray N. Rothbard, "New Light on the Prehistory of the Austrian School" in Edwin G. Dolan, ed., *The Foundations of Modern Austrian Economics* (Kansas City, Mo.: Sheed & Ward, Inc., 1976), p. 54.

3. While the English Classical economists gave us many important ideas regarding creation of wealth and the importance of laissez faire, their value theory was less than desirable and, according to Joseph Schumpeter, actually pushed economic analysis down the wrong path (Rothbard, p. 53).

4. William L. Anderson, "In Praise of Athletes' High Salaries," *Ideas on Liberty,* August 2000, p. 9.

5. Carl Menger, *Principles of Economics* (New York: New York University Press, 1976), p. 65.