Study finds financial parasitism contributes to the high cost of drugs

Nick Beams
18 July 2017

An article published in the *New York Times* on Friday, authored by business and finance journalist Gretchen Morgenson, on the pharmaceutical industry and US drug prices, points to one of the most significant economic phenomena of the present day—the rise of financial parasitism.

It is based on a working paper published last week by the Institute for New Economic Thinking which shows that the exorbitant cost of drugs in the US—the highest in the world—has got nothing to do with the claims by the companies that high prices are needed to stimulate vital research but is the result of financial operations to promote "shareholder value," principally via share buybacks.

The article cites the findings of the research by the institute which showed that from 2006 to 2015, the 18 drug companies in the S&P 500 index "spent a combined $516 billion on buybacks and dividends. This exceeded by 11 percent the companies' research and development during these years."

According to the authors of the study: "The key cause of high drug prices, restricted access to medicines and stifled innovation, we submit, is a social disease called 'maximising shareholder value.'"

The study found that in many cases the big pharmaceutical companies are living from patents that are decades old rather than the development of new drugs. And often the development of so-called "blockbuster drugs" is not the result of research by the major firms, but by smaller start-up companies, which are then taken over by the pharmaceutical giants.

The promotion of shareholder value through share buybacks is driven by a system in which the remuneration of the chief executives of a major firm is increasingly based on rewards for stock market performance.

From 2006 to 2015, the 18 companies in the S&P distributed 99 percent of their profits to shareholders, some 50 percent as buybacks and 49 percent as dividends. During this time the total compensation of drug company executives among the top 500 executives in the US increased at a faster rate than their cohorts, much of this taking place in the period 2012 to 2015, with stocked-based pay accounting for 90 percent of the total.

As the study co-authored by William Lazonick, a long-time researcher into the issue of changes in the stock market over the past three decades, and four others noted: "In the name of 'maximising shareholder value' (MSV), pharmaceutical companies allocate the profits generated from high drug prices to massive repurchases, or buybacks, of their own corporate stock for the sole purpose of giving manipulative boosts to their stock prices. Incentivising these buybacks is stock-based compensation that rewards senior executives for stock-price 'performance.'"

"Like no other sector, the pharmaceutical industry, puts a spotlight on how the political economy of science is a matter of life and death."

The claim by the major pharmaceutical companies that their high drug prices and profits are necessary in order to fund risky research and development is refuted by an analysis of the data. Two of the biggest drug firms, Pfizer and Merck routinely distribute more than 100 percent of their profits to shareholders. Between 2006 and 2015, Johnson & Johnson, Pfizer and Merck spent an annual average of $4.2 billion, $6.3 billion and $3.0 billion, respectively on buybacks, with Amgen, another large pharmaceutical firm spending $3.2 billion a year.

In their study, Lazonick, et al., make the point that share buybacks as a means of profit distribution differ in form from the distribution of dividends. The rationale for the payment of high dividends is to provide a reward for investors who have placed their money in the company's shares, encouraging them to hold them.

Share buybacks operate according to a different logic. They are aimed at providing massive gains for shareholders who decide to sell when the price of the stock rises as a result of the buyback operations.

"The most prominent sharesellers are those corporate executives, investment bankers, and hedge-fund managers who can access non-public information to time their stock sales" to take advantage of buyback activity, they write.

One of the key legal mechanisms driving the process is the protection of so-called intellectual property rights, enabling the drug companies to extract what amounts to a rent from the appropriation of socially-developed scientific knowledge for private interests and profit.

In all cases, the "breakthroughs" in the development of a new drug rest upon decades of basic scientific research, much of it done in publicly-funded institutions, especially in the field of genetic engineering.

A crucial step in the establishment of the legal framework, the study noted, was the Bayh-Dole Act of 1980, which "facilitates commercialization of federally funded research" and has "given away too many of the benefits of taxpayer-funded research to business interests."

The authors of the study conclude that "promulgated in the name of 'value creation,' MSV is actually an ideology of value extraction."

And as other studies note, including one cited in the *New York Times* article, the financial operations in the pharmaceutical industry are part of a much broader process.

According to research conducted by Robert Ayres and Michael Olenick at the global business school, Insead, there has been a dramatic increase in spending on share buybacks and dividends over the past three decades. As a proportion of profits the allocation has increased from low levels in the 1980s to 38 percent in 2000, 63 percent in 2009, 79 percent in 2011, reaching 115 percent in 2015.

This process has been facilitated by the availability of borrowed funds at ultra-low interest rates as a result of the policies of the US Federal Reserve.

The authors conclude that this draining of profits away from reinvestment in productive activities is one of the causes of secular stagnation, which has seen productivity levels fall in the US and a marked slowing of the growth in the US economy, and a continuous fall in real wages.

In another study, William Lazonick points to a reversal in the operations of the stock market over the past three decades. Up until the mid-1970s, net equity raising, that is the issuing of more shares, was around 0.58 percent of gross domestic product. But since then the figure has turned increasingly negative as a result of share buybacks such that in the period 2006-2015 net equity issues as a percentage of GDP was minus 2.65 percent.

In other words, over the 30 years the stock markets have functioned not as a means for expanding the productive base of corporations but the extraction of "trillions of dollars from business corporations in the form of stock buybacks" in a process which Lazonick characterises as the "legalized looting of the US industrial corporation."

While the effects are not so clearly discernible as in the pharmaceutical industry, this is no less a "life and death question" for millions of workers and their families for such looting has led to the destruction of millions of jobs, the slashing of benefits, the replacement of full-time jobs with part-time and casual positions and the endless downward pressure on real wages.

As is the case with so much of the research conducted from a left liberal standpoint, the political conclusions drawn by the authors fall far short of what has actually been revealed by their own analysis.

Lazonick, for example, calls for increased government regulation and for pharmaceutical industries to "reject MSV and begin a transformation to innovative enterprise"—as if the devil could voluntarily cut off his own claws.

The basic flaw in this, and similar analysis, is that the systematic looting of the economy by finance capital is presented as the outcome of some ideology, whether it be dubbed neo-liberalism or the doctrine of maximising shareholder value. The crucial turning point is seen as the ascendancy of Ronald Reagan and Margaret Thatcher to the US presidency and the British prime ministership respectively, as if these two rather limited individuals brought about a world-historic shift in profit accumulation.

The rise and rise of financialisation, for which the neo-liberal doctrines certainly provided the rationale, however, was itself a product of contradictions rooted in the capitalist economy itself, based on the striving for profit by all means necessary, including the parasitic appropriation of already created material wealth and scientific knowledge.

The facts and figures on the pharmaceutical industry and the more general process of which they form a part, establish the overwhelming case for the public ownership of these and other giant corporations, together with the banks and financial institutions which increasingly drive their activity.

Such a program, however, cannot and will not be carried out within the present political framework. It requires the taking of political power by the working class and the reconstruction of the entire economy on socialist foundations.