unjustifiable price premium on the brand name drug. This system amounts to insuring drug quality by what is tantamount to private taxation, and levied through the charging of prices far above production costs. But this does not eliminate the production of substandard drugs, since FDA studies show that a disturbingly high percentage of both brand and generic name drugs do not meet requirements. It should be cheaper to institute universal FDA inspection, of plants *and* products. While the cost to the government might increase (unless as in the case of meat inspection, the companies were to pay the salaries of the inspectors) the resulting increase in price competition which should be expected, once arguments that low price means low quality become manifestly specious to all, should reduce the expenditures of drug buyers greatly.[28]

2. Influence of Economic Aspects of Drug Distribution on the Supply of Drugs

There is one complaint voiced by the drug manufacturers with which I have some sympathy. While about 50 per cent of the retail price of drugs is accounted for by distribution costs and markups, rather more than 50 per cent of the criticism of high drug prices has been centered upon the manufacturers. The proximate cause of the seeming disproportion in attention given the drug makers would appear to be the great visibility of their profit achievements—outstandingly high average profit levels over the last 15 or 20 years—in contrast not only with the absence of any data to show that the druggists have been similarly successful in feathering their nests, but even a general impression to the contrary. The number of retail pharmacies seems to have declined during the period of greatest drug firm success, and many pharmacists who have failed to make what seemed to them a reasonable living in their own profession have reportedly been hired by the drug industry, where they can obtain more remunerative—if perhaps less productive—employment.

But low profit margins in themselves do not necessarily attest to effective competition, since not even a complete monopolist is assured of high profits unless he can operate efficiently. On the other hand, not all inefficiencies are necessarily traceable to the mismanagement of the individual firm. Some inefficiencies may be thrust upon the distribution level from without; others may be unintended consequences of policies fostered within group itself. But before looking into these questions, it is first useful to distinguish between wholesale and retail distribution.

The wholesaling function seems to be the most efficiently performed stage in the industry, chiefly because the wholesaler operates in the most competitive market. Drug manufacturers have their markets protected by patents, trademarks, sales promotion outlays, and the relatively small number and large average size of the major firm. Druggists also enjoy rather protected markets because of the practice of brand-name prescribing, antisubstitution laws, and other regulations which put the consumer at a disadvantage, plus the advantages associated with being a closed profession regulated by semi-autonomous professional associations which have at least the potential for limiting the number of qualified practitioners and hence influencing the rate of entry into pharmacy. The wholesaler, however, has no comparably strong bargaining position. There are many wholesalers, mostly very small, and no appreciable barriers to new entry. Furthermore, if drug makers can perform their own wholesaling functions more efficiently than the independent distributor, they will integrate forward and sell directly to retailers. And if retailers can do better for themselves

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[28] I am aware of no recent estimates of the cost of making FDA inspection fully adequate. However, an order of magnitude approximation of the relation of probable costs to required cost reductions can be made from data presented at the Kefauver Hearings. In 1959, FDA Commissioner Larrick stated that it would take a budget increase of $3,418,000 to permit adequate drug inspection. Profits of the 22 major drug firms were $562 million in 1958. A decline in drug prices sufficient to cut drug firm revenues by $7,121,000 would of course cut before-tax profits by the same $7,121,000. With a tax rate of 52% in effect at that time, this reduction in pre-tax profits would have cut tax receipts by $3,705,000. The net gain can be roughly measured as the $7,121,000 saved by drug buyers, minus the $3,705,000 in reduced tax receipts, or the required $3,418,000. Thus if adequate drug inspection could create confidence in lower-priced drugs to the extent that the resulting competition would lower major drug firm prices by enough to cut total profits by as little as 1.27 percent before taxes, the savings realized would pay for the expanded enforcement budgets. If total profits are about 20% of gross revenues, the necessary percentage price cut would be as little as 1/5 of the 1.27 percent, or 1/4%. See Hearings of Administered Price, *op. cit.*, Part 22, p. 12132.