

rated with advertising appeals, such that although it is necessary for each firm to maintain current sales promotion levels in order to offset the efforts of others, incremental advertising expenditures will have no real impact; therefore, profit rates remain above risk-determined levels because additional spending on sales promotion, and possibly even on production competition, simply doesn't lead to even the prospect of further differential gains. In such a case, the only remaining tactic to bring profit rates down to equilibrium levels consistent with risk (regardless of the nature of the risk, whether inherent or artificial) is price competition, and drug industry repugnance to this force, plus the fact that the number of sellers in each market; that is, effective competitors is still too small to compel price competition, generally results in a sort of high-profits truce between companies which refuse to engage in the price competition which would effectively reduce profit levels to equilibrium relationships in comparison with true risk. (However, Mr. George Squibb's testimony with regard to the frequency of special deals to distributors indicates that although list price competition may be unknown, there may be a substantial amount of hidden competition in terms of such special inducements to dealers. And I suspect that excess capacity in production processes is probably a major reason for this.)

Mr. GORDON. Are you aware that one of the risks attributed to the drug industry is the possibility that the industry may become competitive?

Dr. STEELE. I think this is true. I think Mr. Squibb also alluded to this risk in his statement.

Senator NELSON. Well, in economic terms, is competition considered a risk?

Dr. STEELE. Well, I think it is really a pleasant risk. Competition would not be a risk in itself. In comparing two equally competitive industries, one would expect that the rate of return would be greater in the inherently more risky industry. But if an industry, let us say, had been monopolized, and there is a likelihood that for one reason or another, competition will break out, then investors will see this as a risk in the sense of the institutional frame of risk or something like that, but it won't be something that is inherently in the market structure of ordinarily competing sellers.

(2) Professor Cootner does formally recognize the possibility that the firms might react to profit reduction measures by reducing the riskiness of the ventures in which they engage. But the relevance to the drug industry is limited since the example mentioned assumes that the risk taking activities hypothetically curtailed are socially productive, and do not consider the possibility that these risk taking activities are also creating.

(3) Cootner makes two statements which are not quite compatible. On page 8 he states: "This basic conclusion is that as risk rises so does the required rate of return." But the "required" rate is a subjective expectation; it is basically an ex ante phenomenon. However, on page 4, Cootner states that "one should not be surprised to find large average profits in risky enterprises \* \* \*" which is not quite the same thing. One would expect to find large average profits for companies making profits, but if true risk is significant, also large average