The Prescription for Drug Costs

by Heather Burns, Charles Beever, and Robert Hutchens

The cost of health-care benefits has continued its unrelenting rise this year: Premiums rose 13.9 percent between May 2002 and May 2003, according to an annual survey of nearly 3,000 companies by the Henry J. Kaiser Family Foundation and the Health Research and Educational Trust. This marks five consecutive years of increases above 5 percent and the highest jump since 1990. It parallels a persistent uptick in overall health-care spending in the U.S., which almost doubled between 1990 and 2000, from $655 billion to $1.2 trillion. The biggest contributor to this increase was spending on prescription drugs, which tripled during that time from $40 billion to $122 billion, or from 6 percent to 10 percent of health-care expenditures.

These trends have many companies rethinking the generous health-care benefit packages they have used to attract and keep talent in a highly competitive economy. But the more fundamental questions are, Why are drug prices going up so fast, and what can and should employers do about it?

Critics of rising drug costs in the media, in government, and elsewhere blame aggressive marketing by big pharmaceutical companies, pointing to "mega" sales forces calling on physicians and the persuasive television ads the critics say compel consumers to pressure their doctors to prescribe unnecessary or inappropriate drugs. But the truth is more complicated. In fact, there's an institutional force that's harder to control and reform: It's the third-party reimbursement system, led by employers, insurance companies, and government programs (collectively referred to as the "payers"), that erodes patients' personal accountability for their health-care decisions and distorts doctors' treatment decisions.

The evidence has long suggested that third-party payments significantly affect health-care spending. The proportion of medical care expenditures covered by third parties, including government programs, rose to almost 70 percent from roughly 48 percent between 1960 and 1980. In that period, medical costs as a percentage of GNP nearly doubled, to 9 percent from 5 percent. Although factors other than third-party reimbursement (e.g., 25 percent population growth and a 50 percent increase in the number of people over 65) also drove up medical care spending, these factors don't explain the magnitude of the increase.

During those 20 years, 1960 to 1980, expenditures on pharmaceuticals as a percentage of overall health-care spending actually fell by half, from 10 percent to 5 percent, mainly because most consumers paid for drugs out of their own pockets. Since the beginning of the 1990s, however, there has been a dramatic shift to third-party payment for pharmaceuticals. In 1992, third parties covered only 38 percent of full-time employees' spending on medicines; in 2001, it reached 88 percent.

To be sure, drug spending wouldn't have ballooned so quickly without other trends, such as increased diagnosis of common diseases like asthma and diabetes, innovative new treatments for such conditions as osteoporosis and anemia, more cost-effective applications of drug therapies, and the pharmaceutical industry's spending on sales and marketing. Nevertheless, the growing role of third-party reimbursement provided the fertile soil in which the healthy growth in drug expenditures took place.

Third-party reimbursement distorts how patients and physicians make pharmaceutical and other treatment decisions, because those decisions are actually in the hands of payers and their agents (pharmacy benefit managers, or PBMs).

In plans without patient co-payments, patients and physicians are entirely insulated from the economic consequences of their choices. Payers can and do shift costs back to patients using co-pays. But the payers and their agents still decide which products merit low co-pays, and they negotiate the prices with manufacturers. For example, prescription drug benefit plans commonly sort co-pay amounts in three tiers, with co-pays of roughly $10, $15, or $20 per prescription. The tier a drug is on (and therefore the size of its co-pay) depends on whether it is "preferred" by the plan. To qualify a drug for a lower co-pay, pharmaceutical companies offer discounts to benefit plans. Such arrangements are now used in more than 70 percent of prescription benefit plans.

Co-pay programs are also typically designed to influence unit volume (the number of prescriptions) more than prices. Because the patient pays a fixed co-pay no matter what the price of the prescription, there is no incentive for the patient to select a less expensive alternative. Payers theoretically should want to push for lower prices. But their incentive to do so is usually attenuated because they do business through PBMs that make their money by capturing some portion of the discounts drug companies offer in exchange for co-pays.

Third-party reimbursement distorts how patients and physicians make treatment decisions.

So how can companies that want to continue to provide attractive health benefits give their employees a more direct economic stake in their health-care choices and moderate the upward rise in drug prices? In our view, defined-contribution or consumer-directed health plans are part of the solution. What consumer-directed plans do is place the decision about the "right" level of pharmaceutical spending where it belongs — in the hands of patients and physicians. Rather than pay for health care on a prescription-by-prescription or visit-by-visit basis, the employer contributes a fixed sum that employees can spend as they see fit.

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Some argue that individual employees lack the power of large health plans to push back on pharmaceutical price increases. But our research suggests otherwise. A recent Booz Allen Hamilton survey of health plans shows little or no correlation between the size of the plan and the discounts it receives from pharmaceutical companies. Instead, discounts are triggered mostly by the plan's ability to shift market share from one drug to another.

As patients begin to vote with their wallets and select prescription medicines on the basis of not just performance but also price, pharmaceutical companies will respond. As drug companies compete to make their case directly to patients and physicians, there will be more market pressure to temper rising prices and indirect pressure to lower marketing and advertising expenditures. Pharmaceutical prices and spending may or may not drop as a result, but at least it will be the patients and physicians who are making the choice. ✚

Applied Governance: Beyond Compliance

by Worth D. MacMurray

The recent legal, regulatory, and other responses to reported corporate transgressions have broad and, in some respects, still uncertain implications for public companies. A growing number of organizations are appointing a chief compliance officer (CCO), or an equivalent, such as a chief governance officer or chief ethics officer, to be a single and senior point of contact for Sarbanes-Oxley, stock exchange, and other requirements. Computer Associates, Kodak, Peregrine Systems, Pfizer, SunGard, and Westar Energy are among the companies that have formalized the position. The trend will continue as boards and management realize that the role transcends "policing" and actually contributes to growth and resiliency.

Originally conceived to address the compliance needs of some highly regulated industries, a full-time CCO can provide direction and substance to public companies in meeting their evolving corporate governance requirements — whatever the industry. The role involves the communication and application of both universal and company-specific corporate governance themes, through the creation, implementation, and continuing refinement of practical processes and methodologies.

To promote and codify the universal themes of transparency, integrity, and accountability, the CCO, working with the general counsel, chief financial officer, and internal auditor, can manage and document Sarbanes-Oxley and stock exchange compliance requirements. He or she also can act as an internal and external facilitator for board committee chairs, and lead the planning process associated with the company's efforts to mitigate risks and ensure the company's ability to adapt and grow through discontinuous change.

The CCO also can help a company implement the practical changes these broad themes imply. For example, the revenue recognition, expense classification, and other accounting flaws at Enron, WorldCom, and others were in many cases basic process problems. A good compliance officer can introduce activities to increase transparency, such as eliminating departmental "silos," reducing manual data entry and transfer points, and instituting periodic below-officer-level interdepartmental meetings to address common problems. Reinforced by consistent management actions emphasizing integrity and accountability, these can improve the quality of internal communications and operations.

Activities of this kind constitute *applied* corporate governance. They take governance themes and embed them in core corporate activities, addressing primary operational and legal risks and the expanding responsibilities (and liabilities) faced by officers and directors. Although the CCO is not a guarantor of stellar corporate governance or squeaky-clean operations, a senior officer dedicated to these issues is likely to produce positive change and diminished risk.

From a financial perspective, the role adds value and can pay for itself many times over in two ways: cost savings and strategic differentiation. Cost savings are achieved through internal risk control and resiliency activities, namely, the identification and mitigation of compliance and/or interdependency problems at earlier, less costly stages. Strategic differentiation occurs as companies aggressively communicate the existence of the role and its application to the specific concerns of various critical constituencies.

Specifically, the CCO's position offers six direct benefits to the company and its key constituencies:

• Added credibility with customers, resulting in additional revenues.

• Less risk for partners, resulting in better company purchase and/or deal terms.

• Increased trust and confidence among employees, resulting in greater loyalty and productivity, less turnover, and the preservation of intellectual capital.

• Less risk to the company in capital markets, resulting in higher valuations, lower capital costs, and improved scores from institutional corporate governance rating services.

• Less risk for directors and officers' insurers and other insurers, resulting in less costly policy premiums.

• Less personal risk for senior officers and board members, resulting in both professional value (the existence of the role reflects positively on the company) and personal value (less chance of individual lawsuits).

As with any corporate role involving changes to the status quo, a variety of issues affect the CCO's ability to be effective. The conditions for success include:

Related Experience. A CCO should be sufficiently senior and experienced to have dealt with boards and senior management on a variety of complex issues. Former general counsel or chief financial officers are good candidates.

Independence. Ideally, the CCO should report directly to the audit or governance committee, and should have an independent budget flowing from that committee. Without a reporting relationship to the board, the CCO position is more likely to be seen as "business as usual," with marginal value to external and internal stakeholders. Similarly, budget dependency on management creates control (and role diminishment) problems.

Title. A corporate officer title signifies that the company takes the role seriously.

Board and Senior Management Support. Consistent and visible backing for both the position and the specific goals and themes it represents (as shown by the company's code of ethics and business conduct policies) is critical. "Tone at the top" is constantly measured by employees. Similarly, whether or not management's actions follow policy and principle in the presence of inconvenient facts sends strong signals to the work force.

Sales Management Support. The support of the revenue-generating side of the business is also important. This group will quickly decide whether a given role or activity will help or hinder sales, and will respond accordingly. The CCO should therefore position the role as one of practical "sales facilitation," and then deliver value through identifying and eliminating unnecessary steps in sales processes (while still advancing compliance goals) and, in the right situations, participating in sales calls with customers.

The creation of this position is a corporate opportunity to go beyond the letter of Sarbanes-Oxley and related requirements toward applied corporate governance. A hands-on, business-oriented CCO can translate the often amorphous elements of transparency, accountability, and integrity into positive actions — and produce tangible benefits. ✚

What Will Be Made in China

by Barry Jaruzelski and Jay Kumar

It is increasingly likely that the television set, computer, or PDA you purchase in the next few years will have been made in China. In fact, China is grabbing the lion's share of the electronics manufacturing that, increasingly, is moving to developing countries.

Given the twin needs to cut costs in this hypercompetitive industry and find new markets, multinational electronics companies — like other manufacturers before them — are heading to emerging economies, where they can reduce manufacturing labor costs by 80 percent and find growing local demand for their products. Although many industries have shifted assembly offshore, what is different in the case of electronics manufacturing is the speed of the shift and the fact that a significant number of high-value, knowledge-based jobs like design and engineering are involved.

Today, 16 percent of all electronics manufacturing — $65 billion worth — occurs in developing countries. According to a study published in June 2003 by the International Finance Corporation (IFC), the private sector arm of the World Bank, and Booz Allen Hamilton, electronics manufacturing in Latin America, Eastern Europe, and Southeast Asia (not including Hong Kong, Korea, Singapore, and Taiwan) will nearly double in value to $125 billion by 2005, accounting for 43 percent of total worldwide manufacturing growth. Three-fourths of electronics production growth will occur in China, at a rate twice as fast as that in any other developing country. However, Russia, India, Mexico, Romania, Bulgaria, the Ukraine, Malaysia, and Thailand are also countries to watch.

China currently accounts for more than half of the emerging-market electronics production and 8 percent of the total global production. In the future, it will take a commanding lead in key value chain elements; for example, it will account for more than half of all final assembly activity by 2005. Higher-margin activity, such as design and engineering, will move there as well, but not as rapidly as production will.

Several factors explain China's attraction. First, it has made electronics a priority, and it is sweetening the pot with highly subsidized financing. In some cases, to draw multinational investment, the government even provides facilities and equipment. As a result, electronics production in China is expected to surpass Western Europe's production, reaching $80 billion in 2005. China's growing base of talent and experience is also a lure; some Chinese who study engineering and other disciplines in the United States are now returning to China to provide leadership.

In addition, a "cluster" effect is taking hold: As the electronics industry in China matures, foreign manufacturers can find suppliers nearby, which makes manufacturing more efficient. The traditional fears of developed-country manufacturers operating there — that China is too far from the markets to which they are selling, that their products are too high-tech to be produced in a developing country, that the transportation infrastructure isn't good enough, and that the necessary parts for manufacturing aren't available — are slowly disappearing.

Multinational electronics producers are also interested in China because they want to penetrate its huge market, now the world's largest market for cell phones and color televisions, and the second largest for personal computers, after the United States.

China's importance was emphasized when the Dell Computer Corporation reported its second-quarter results for 2003. Total unit volume in China grew 71 percent, the third straight quarter that the increase was higher than 65 percent. Dell's server shipments within China were up 79 percent, and notebook computer shipments doubled. Chip manufacturers are also moving production to China to take advantage of the computer and communications device consumption boom there. In August 2003, the Intel Corporation announced it would build a $200 million semiconductor assembly and testing factory in China.

The Chinese government has its own reasons for encouraging electronics multinationals to manufacture in China — it wants their money, technology, and expertise — even as it is funding promising indigenous companies' expansion locally and overseas.

The growth of manufacturing in emerging markets, especially in the electronics industry, is inevitable. But it will not come without challenges. Labor costs are rising in China, which reduces the benefits of moving production there. The production of goods for the military isn't occurring in any of these countries yet, for security reasons. There are also significant risks associated with weak intellectual property laws, especially in China.

Still, firms are learning how to manage these risks. At this time, the world's leading electronics companies are not shifting production of their most complicated products and cutting-edge technology to China, because of concerns about intellectual property protection. To strengthen their local capabilities in China, companies are transferring experienced executives from their home country to fill senior management positions, and they are moving some production out of coastal regions where labor costs are rising rapidly. In all emerging-market countries, multinationals are conducting more due diligence on management issues, such as governance structures and local staff qualifications, before partnering with local firms.

It is far better for today's global electronics companies to prudently bear the risks of manufacturing in China and other emerging markets than to lose out on the opportunities in this historic shift. For most companies, taking these risks is a competitive necessity. +

The Company's Mission Is the Message

by Bill George

The greatest myth of the last decade is that CEOs who run their companies to maximize shareholder value actually serve their investors well. In truth, by running their businesses by the numbers in order to get the stock price up, and thus attempting to please their shareholders in the near term, these leaders are putting their companies on a course to long-term decline or even eventual destruction. Business's best-kept secret is that mission-driven companies accrue far more shareholder value than do financially driven firms.

When I joined Medtronic Inc. in 1989, it had a market capitalization of $1.1 billion. I asked a senior board member what would happen if a raider were to offer our shareholders $2 billion for the company's shares. Reflecting on the shareholder pressures at the time, he said reluctantly, "We would be gone." To which I responded, "Then the board must not believe in the value of the company's future prospects or its mission." Right then, I vowed to myself to build on the Medtronic mission to create such a valuable company that it could not be taken over.

That mission dates to 1962, five years after Medtronic founder Earl Bakken invented the pacemaker, when the company was near bankruptcy. At the time, Mr. Bakken, urged on by his board of directors, wrote Medtronic's mission: To restore people to full life and health. This mission inspires employees to do superior work with dedication and passion — when they share patient stories, when they challenge one another to ensure that the quality of Medtronic products is high enough, when they think about new inventions. Leaders regularly refer to the mission before making strategic decisions.

This has led to spectacular results for patients, career opportunities for employees, and a dramatic rise in Medtronic's shareholder value. From 1985 to 2003, shareholder value grew at a compound annual rate of 32 percent. Today, Medtronic is one of the 30 most valuable companies in the U.S.

When raising the stock price is the priority, it takes precedence over considerations of marketplace competitiveness and customer satisfaction — crucial elements for building value over time. And when top management runs out of options to immediately increase shareholder value (which it usually does), it tries to restructure to achieve financial goals. Nonstrategic acquisitions, divestitures, consolidations, layoffs, and cutbacks generally follow. By the time such restructuring is done, the corporation has lost its capacity for growth. Meanwhile, impatient investors won't give the CEO the time needed to revive the business. Instead, shareholders press for a change in leadership, or even the sale of the company.

But the worst failing of being financially driven is that such a culture doesn't rouse most people to strive for exceptional performance. Granted, a few top executives have the promise of substantial wealth motivating them. But they're only a small fraction of the organization. Financial incentives are far less meaningful for the majority of people who design, manufacture, and sell products and services.

In my experience, getting employees to feel a sense of purpose beyond making money is the *only* way for a company to consistently deliver innovative products, superior service, unsurpassed quality, and, ultimately, shareholder value. Eventually, competitors can copy an innovative idea for a product or service. But an organization of highly dedicated people — who work into the night to accelerate the introduction of an important new product, or respond on a weekend to a customer's urgent call for service — is hard to duplicate.

Getting employees to share a purpose beyond making money is the only way to consistently deliver shareholder value.

Furthermore, employees who place a high personal value on their work are remarkably resilient, even when cutbacks and layoffs are required.

Is this ability to create a meaningful mission limited to companies like Medtronic that are in the business of saving lives? Not at all.

Being a leader in innovation has motivated the employees of 3M to be creative throughout the company's history. Intel employees are unwavering in their efforts to keep their company on the forefront of technology and to use that technology to serve their customers. Microsoft employees are inspired by integrating all the software their users need into a single, highly functional system.

Even in an industry in which managing money is the purpose of the business, one can see stark differences between the mission-driven and shareholder value–driven approaches. Two major U.S. banks, Wells Fargo & Company and U.S. Bancorp, have roots in Minnesota. For the past 10 years, Wells Fargo has focused on providing superior customer service, expanding its network of branch banks throughout the Midwest and West. U.S. Bancorp, on the other hand, has concentrated on cost cutting and centralizing services. At first, it appeared U.S. Bancorp had the superior strategy, because its stock soared when cost cutting led to large profit increases. But lack of attention to the customer and problems with employee morale eventually caused revenue and earnings growth to stall. Its stock lost over half of its value, leading to the company's sale to a smaller Milwaukee banking group. In contrast, Wells Fargo's growth was steady, even during the recent recession. Its shareholder value is now double that of U.S. Bancorp.

Authentic leaders know that only by having a meaningful mission — and pursuing it with passion — will companies survive and increase the value they can deliver to customers, employees, and their shareholders. ✚