

# FOREIGN AFFAIRS

MARCH/APRIL 2001

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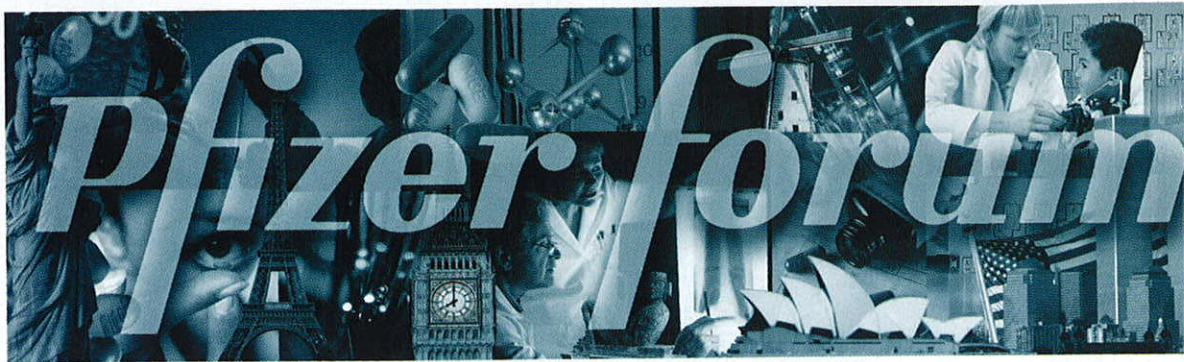
### THE AGE OF TECHNOLOGY

Christensen, Craig, & Hall on Disruptive Innovations,  
Barshefsky on Trade Rules for the New Economy,  
Hachigian on China's Cyber-Strategy, and  
Hammond and Persaud on Bridging the Digital Divide

*Plus Selig Harrison on North Korea,  
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and Jeffrey Frankel on Jagdish Bhagwati*

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## The Pharmatech Industry in the New Economy

by Merrill Matthews, Ph.D.

The cost of prescription medicines has become a hot topic of debate in many countries. Critics assert that drug prices are too high, and some advocate de facto or explicit price controls on prescription medicines. But are price controls good policy? How would they affect the ability of drug companies to research and develop new medicines? And how many deadly or debilitating diseases might go untreated or uncured as a result?

Differing research and development costs help to explain why some drugs are affordable while others are expensive. In 2000, pharmaceutical companies world-wide will spend more than \$26 billion developing and testing new drugs. These companies have to recover their costs in order to continue researching new cures and treatments. Price controls reduce incentives to discover new medicines, and they would lead to political rather than technological considerations in determining what drugs to develop – and whom to treat.

There are two different pharmaceutical industries. The first mass-produces generic medicines, aspirin, cold medicines, ointments and other over-the-counter (OTC) drugs. This industry fits nicely into an Old Economy model in which competitors try to produce products or services similar to those of more successful rivals, but at lower prices. The other pharmaceutical industry – the “pharmatech” industry – follows the New Economy model in which companies spend heavily to create and test a patentable product, but then incur minimal reproduction costs. In the New Economy,

A world of ideas on public policy.

the primary barrier to entry is the high cost of developing an innovative product that can then be patented, thereby enabling the discoverer to recoup its costs.

### The pharmaceutical industry's need for temporary patent protection is an inherent function of a high-tech industry in an information-based economy

Unlike Old Economy companies that sell the same product year after year, pharmatech and other New Economy companies can earn profits only by continually releasing new or upgraded products. The pharmaceutical industry's need for temporary patent protection is an inherent function of a high-tech industry in an information-based economy. The price of innovation is temporarily high costs for certain medicines. Price controls threaten to restrain or undermine that innovation.

Although many prescription drug manufacturers are profitable, those profits are not out of line with other successful New Economy industries that produce high-demand products – or even with some Old Economy companies that market patentable or copyrighted material. In fact, most drug companies are profitable not because they charge excessive prices, but because doctors and patients want their products so much. Although pharmaceutical spending increased at a 13.7 percent average annual rate between 1995 and 1999, most of that increase resulted from increased sales volume, not higher prices. Consequently, price

controls would do little to restrain overall drug spending.

If public officials really want to control prescription drug prices, they would do well to rely on competition rather than on government fiat. In fact, the drug industry is already competitive – no single pharmaceutical company controls more than 7.2 percent of the U.S. market. Moreover, increased spending on direct-to-consumer advertising and R&D indicates that the pharmaceutical industry is becoming still more competitive as companies vie for market share. If market forces are allowed to operate, that competition will eventually lead to lower prices.

Competition in a market free of excessive regulation is the best way to keep drug prices low. Price controls almost invariably inhibit research and development, and result in shortages and rationing – as the experiences of Europe and Canada demonstrate. In contrast, when drug companies face the need to compete more effectively, they voluntarily reduce prices and seek new ways to get innovative products to market faster.

Educating patients about the benefits the drugs they buy gives them a sense of value for money. And when consumers perceive that they are receiving value for the drug dollars, they are less likely to care about how much profit drug companies make.

*Dr. Merrill Matthews is a Visiting Scholar at the Institute for Policy Innovation (IPI) in Lewisville, Texas. This article is excerpted from Dr. Matthews's new Policy Report, Prices, Profits and Prescriptions: The Pharmatech Industry in the New Economy. The full report is available at [www.ipi.org](http://www.ipi.org) <<http://www.ipi.org>> or by calling +972/874-5139.*

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### Come Partly Home, America *Michael O'Hanlon* 2

America should not abdicate its military duties abroad. But careful cuts in the number of U.S. troops overseas could alleviate some current problems—such as poor troop morale and low readiness—without sacrificing U.S. interests or strategic goals.

### Asia's Bad Old Ways *Hilton L. Root* 9

The crony capitalism of Asian firms was once a rational adaptation to their business environment, but it is now outdated. Rather than preaching or bullying, the West should have faith that the need for foreign capital will spur the necessary changes.

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America now faces the prospect of economic conflicts with both Europe and East Asia. The United States and the European Union have already fired the first shots of retaliatory sanctions over their ever-growing trade disputes. On the other side of the world, meanwhile, Asian countries are creating a bloc of their own that could include preferential trade arrangements and an Asian Monetary Fund. These developments could produce a tripolar world and hamper global economic integration. To avert this outcome, the United States must quell its domestic backlash against globalization and reassert its economic leadership in the world. The new Bush administration should make multilateral trade liberalization a top priority—or it will face unpleasant economic and political consequences as the U.S. and foreign economies slow.

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 After all the recent bloodshed in the Middle East, many have pronounced the Oslo peace process dead. But Oslo's core principle—that peace requires an end to the Israeli occupation of the West Bank and Gaza—remains as sound as ever. Friendly cooperation between the two sides appears a long way off; even final-status talks may be premature. But in the interim, there is one step Israel can and must take: withdrawal from the territories, whether the Palestinians are ready or not.
- The Uneasy Americas *Peter Hakim* 46  
 Hemispheric relations seem at an all-time high, as democracy and prosperity blossom throughout Latin America. But President Bush still faces potential problems south of the border, from mission creep in Colombia to chaos in Peru, from Chávez in Venezuela to Castro in Cuba. And then there is Mexico, where the first-ever democratically elected president is eager to engage Washington—on his own terms. Only one thing is certain: Latin America must not be ignored.
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- ## The Age of Technology
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- Trade Policy for a Networked World *Charlene Barshefsky* 134  
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*The articles in Foreign Affairs do not represent any consensus of beliefs. We do not expect that readers will sympathize with all the sentiments they find here, for some of our writers will flatly disagree with others; but we hold that while keeping clear of mere vagaries Foreign Affairs can do more to inform American public opinion by a broad hospitality to divergent ideas than it can by identifying itself with one school. We do not accept responsibility for the views expressed in any article, signed or unsigned, that appears in these pages. What we do accept is the responsibility for giving them a chance to appear.*

THE EDITORS

## Recent Books

historical episode but a “political religion” that led to an advanced society’s moral breakdown and “moral neobarbarism” across Europe and Russia. Burleigh outright rejects separating fact from judgment and proudly defends the human values that Hitlerism tried to destroy. Indeed, his very indignation and uninhibited style enhance the book’s appeal. He wisely starts the story in 1914, when many Germans citizens abandoned “the business of thinking for themselves.” With formidable documentation, the author demonstrates how the triumph of police terror over the rule of law in 1933 formed the basis of all the evils that followed—including policies toward Jews, eugenics and euthanasia, and occupation in the rest of Europe. Although Burleigh skimps somewhat on the issue of public acquiescence (and enthusiasm) before the war, he exhaustively examines German resistance to Hitler. Many of its members may not have been good democrats, he concludes, but they all sought to restore the rule of law. This account gives Hitler and the war less attention than do other versions, but *The Third Reich* unflinchingly keeps the reader’s mind on the essentials.

*The Political Mobilization of the European Left, 1860–1980.* BY STEFANO

BARTOLINI. New York: Cambridge University Press, 2000, 637 pp. \$69.95.

Armed with charts and masses of data, Bartolini has produced a colossal study of the relations among European labor parties and unions, governments, and bourgeois interests; the role of peasants and religious groups; and the complex split between socialists and communists. He argues that the rigid class identity

(or “cleavage”) of workers became ideologically hostile to the state, with socialism as a final step in the “mass nationalization and integration of the lower classes in the national political order.” In this process, the scope of political representation and citizenship proved far more important than economic development and industrialization. He concludes by arguing that the class cleavage is now in decline, largely because of changes in the social structure. Bartolini’s erudition, mastery of details, awareness of national differences, and virtuosity in explaining problematic cases are astounding. But it is arguable whether even such a clearly written social-science study could throw more light on this subject than less “scientific” but more historically grounded studies. Indeed, the latter might better convey the distinctive flavors of the movements and nations considered—and be more readable.

*The Federal Future of Europe: From the European Community to the European Union.* BY DUSAN SIDJANSKI. Ann Arbor: University of Michigan Press, 2000, 462 pp. \$65.00.

*Federalism and European Union: The Building of Europe, 1950–2000.* BY MICHAEL BURGESS. New York: Routledge, 2000, 290 pp. \$90.00 (paper, \$29.99).

The European Union’s disappointing summit last December underlined how much European integration is caught in conflicting drives and aspirations. The EU’s functional scope is broader than ever, thanks to monetary union and the new move toward a rapid reaction force. Its planned enlargement will extend its reach to the whole continent. But its system of governance is too Byzantine

to function well, too obscure to be understood by its citizens, and too paralyzed by antagonisms. Neither the potential new members nor the United Kingdom seem willing to move toward a more federal structure. The tensions between the smaller and the larger states are acute, and the Franco-German "axis" is cracked.

In these two works, Sidjanski and Burgess focus on the debate between "federalists" and "intergovernmentalists" that has raged for decades. Burgess concerns himself with theories of European integration, trying to measure how far federalism has been achieved. But his conclusion—that the EU has both confederal and federal elements, and these two schemes actually share many common features—is a somewhat disappointing cop-out. (These elements in fact tend to lead in different directions, as the United States found out in its early years.) Sidjanski, in contrast, provides an eminently clear account of the EU's origins and development, arguing that federalism is both Europe's future and the best way to contain excessive nationalism. He devotes much space to the Balkan tragedies, which Burgess barely mentions, but his focus leads him into a different kind of trap. He analyzes the EU's evolution as a troubled yet necessary march toward federalism but fails to ask what it would take to build a European public space—and whether there can be a European federation without a European "people." He seems torn between his faith and his awareness of the obstacles to federation.

*A European Security Architecture After the Cold War: Questions of Legitimacy.*

BY GÜLNUR AYBET. New York: St. Martin's, 2000, 316 pp. \$69.95.  
Aybet attempts to evaluate not just the new architecture of European security but its legitimacy, examining three distinct phases from 1990 to 1995. In 1990–91, the Western security community used institutions such as the Conference for Security and Cooperation in Europe to expand and promote the values forged in the Cold War. During the Persian Gulf War, it proceeded to move from collective defense to collective security. Finally, the Yugoslav wars forced the West to test its values and institutions. Aybet also traces NATO's increasing dominance in the institutional context. She contends that the Western security community has achieved legitimacy through a "Gramscian hegemony," which in turn is bolstered by interlocking institutions and the "consent and adoration of Eastern European dissidents." In other words, the new European security culture is essentially Western rather than truly pan-European. Whether this argument adds to her otherwise incisive study is unclear, but a subsequent volume is certainly needed to go beyond 1995 and assess NATO's Kosovo intervention—when the U.N. was excluded and new questions of legitimacy were raised—as well as Europe's efforts at creating its own rapid reaction force.

*Another Country: German Intellectuals, Unification and National Identity.*

BY JAN-WERNER MÜLLER. New Haven: Yale University Press, 2000, 310 pp. \$27.50.

Europe's intellectuals have played a prominent role as public educators since the Enlightenment. Intellectual discourse has often remained inseparable from a