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Evaluating the Impact of Small Business Set-Asides on Acquisitions Efficiency

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Abstract

The Federal Government spent over $470 billion on procurement in FY 2016. Spending of this magnitude creates opportunities for implementing selected national policies. For instance, current law requires that low-cost acquisitions be reserved exclusively for small business concerns, with qualifying businesses assuming the role of prime contractor. However, the pursuit of admirable social goals such as this may not be rational from an economic or technical standpoint.

This report analyzes the distribution of small business procurement across industry sectors using data from the Federal Procurement Data System (FPDS). We show that a relatively small number of large firms dominate the federal contracting landscape in certain sectors, such as defense, and account for a significant proportion of procurement spending. Accordingly, set-aside policy has a disparate impact on the remainder of the spending, concentrating it into certain industry sectors where there are greater opportunities for small businesses, limiting free and open competition, and creating a series of unintended consequences for government (e.g., contracting and economic inefficiency) and small businesses (e.g., uneven and unsustainable growth and barriers to entry into the federal contracting space).

Introduction

The Federal Government, on average, spent half a trillion dollars annually on procurement over the last decade ($470 billion in FY 2016), roughly 40% more than what was spent in real terms during the 1990s (see Figure 1).

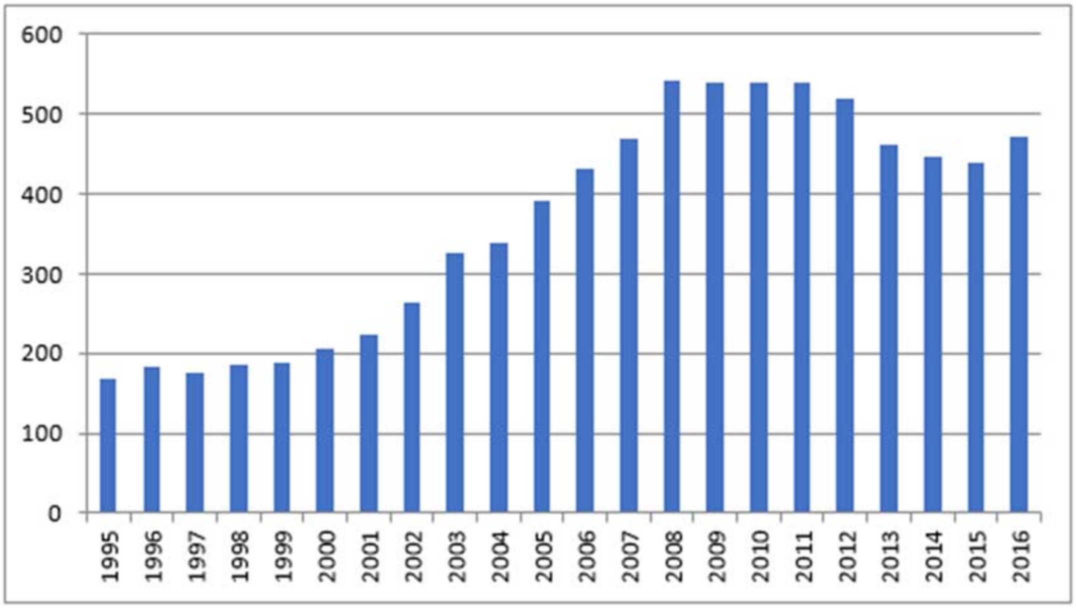

Figure 1. Federal Contract Spending, Action Obligations in $Billions, 1995–2016
(Analysis of FPDS Data)

Spending of this magnitude creates opportunities for implementing socio-economic policies aimed at promoting small businesses, especially those owned by members of historically-disadvantaged groups (i.e., minorities and women). In 1988, Congress began requiring that "the President shall annually establish Government-wide goals for procurement contracts" at specified minimum percentages of procurement (Beale, 2014). The initial government-wide goal for small business procurement was set "at not less than 20 percent of the total value of all prime contract awards." In 1997, the goal was raised to 23%.

As part of these broad socio-economic goals, the Small Business Act of 1953 established the Small Business Administration (SBA) to "aid, counsel, assist, and protect the interests of small business concerns, to preserve free competitive enterprise, and to maintain and strengthen the overall economy of our nation" (SBA 2014). However, as with any effort to regulate a complex system, there are unintended consequences. It remains unclear whether the current set-aside policy, in its current implementation, represents the best strategies for leveraging the capabilities that small businesses can offer.

This report analyzes the distribution of small businesses procurement across industry sectors using data from the Federal Procurement Data System (FPDS). We show that a relatively small number of large firms dominate the federal contracting landscape in certain sectors, such as defense, and account for a significant proportion of procurement spending. Accordingly, set-aside policy has a disparate impact on the remainder of the spending, concentrating it into certain industry sectors where there are greater opportunities for small businesses, limiting free and open competition, and creating a series of unintended consequences for government (e.g., contracting and economic inefficiency) and small businesses (e.g., uneven and unsustainable growth and barriers to entry into the federal contracting space).

The advantages of small business—innovation and agility—have been recognized for decades. Small business is the "driver and engine of growth" and the "lifeblood of our economy" (Obama, 2014). However, there are indications that current set-aside policies fall short of their intended objectives: promoting the growth and prosperity of small business, improving government acquisitions efficiency, and fostering economic growth.

Background

A small business, to qualify as such under SBA requirements, must meet the following criteria:

- Meets SBA industry-specific size standards;
- Is organized for profit;
- Has a place of business in the United States;
- Operates primarily within the United States or makes a significant contribution to the U.S. economy through payment of taxes or use of American products, materials, or labor;
- Is independently owned and operated; and
- Is not dominant in its field on a national basis. (SBA, 2015)

Current law requires that all acquisitions above the micro-purchase threshold of $3,500 be set aside for small business concerns provided that there is a reasonable expectation that offers from at least two responsible small business concerns will be received at fair market prices. This provision is commonly referred to as the “rule of two.”

Set-Aside Goals

In addition, each year the government sets a government-wide small business prime contracting goal. The current goal is 23%. It also establishes goals for small-disadvantaged businesses, women-owned small businesses, historically-underutilized businesses zones (HUBZone), and service-disabled veteran-owned small businesses. There is also a government-wide small business subcontracting goal and subcontracting goals in each of the aforementioned categories. The 2015 set-aside goals and levels of achievement are shown in Table 1.

Table 1. FY2015 Government-Wide Small Business Procurement Goals and Achievement

(SBA, 2016)

Category	Prime Contracting Goal	Prime Contracting Achievement	Subcontracting Goal	Subcontracting Achievement
Small Business	23.00%	25.75% ($90.7B)	34.03%	31.30%
Women-Owned Small Business	5.00%	5.05% (17.8B)	5.00%	5.05%
Small Disadvantaged Business	5.00%	10.06% ($35.4B)	5.00%	10.06%
Service-Disabled Veteran Owned Small Business	3.00%	3.93% ($13.8B)	3.00%	3.93%
HUBZone	3.00%	1.82% ($6.4B)	3.00%	1.82%

Current law also requires that federal agencies, in collaboration with the SBA, establish their own goals biannually in each of the categories listed in Table 1. The goals vary widely by agency. Prior to finalizing each agency’s goals, the SBA determines whether the goals, in the aggregate, meet or exceed the government-wide statutorily mandated goals in each of the categories. The critic might question why agency goals are subordinated to government-wide goals, rather than used to inform, if not justify, the government-wide targets.

The SBA provides each agency with an annual performance scorecard that lists achievement in each category along with an overall grade, using a methodology that heavily weights prime contracting achievement. An agency's grade is composed of three quantitative measures: prime contracts (80%), subcontracts (10%), and its "progress plan" for meeting future goals (10%; SBA, 2015). Accordingly, comparing their letter grades cannot reveal which agencies relied more heavily on small business to meet their procurement needs. Table 2 shows the DoD's 2016 small business procurement scorecard.

Table 2. DoD's 2016 Small Business Procurement Scorecard

Department of Defense
FY2015 Small Business Procurement Scorecard

A
106.34%

FPDS-NG Prime Contracting Data as of Feb. 20, 2016
eSRS Subcontracting Data as of Mar. 14, 2016

Prime Contracting Achievement:			88.02%
	2014 Achievement	2015 Goal	2015 Achievement
Small Business	23.47%	21.60%	24.64% ($52.4 B)
Women Owned Small Business	3.97%	5.00%	4.43% ($9.4 B)
Small Disadvantaged Business	8.95%	5.00%	9.53% ($20.2 B)
Service Disabled Veteran Owned Small Business	3.04%	3.00%	3.45% ($7.3 B)
HUBZone	1.93%	3.00%	1.87% ($4.0 B)

Subcontracting Achievement:			8.46%
	2014 Achievement	2015 Goal	2015 Achievement
Small Business	33.20%	36.00%	32.30%
Women Owned Small Business	5.70%	5.00%	5.30%
Small Disadvantaged Business	4.60%	5.00%	4.40%
Service Disabled Veteran Owned Small Business	2.10%	3.00%	2.00%
HUBZone	1.50%	3.00%	1.40%

SBA Size Standards

One of the challenges created by the small business set-aside policies is defining what a "small" business is. These definitions are tailored to industry classifications and have evolved over time. The SBA devises size standards which are expressed as either the average number of over the past 12 months or average annual receipts over the past three years. The size standard varies by NAICS industry and is dependent on an SBA methodology that analyzes five primary factors within each industry: average firm size, degree of competition within an industry, startup costs and entry barriers, distribution of firms by size, and small business share in federal contracts.

NAICS Codes

The North American Industry Classification System (NAICS) is the standard used by federal statistical agencies, including the SBA, in classifying business establishments for the purpose of collecting, analyzing, and publishing statistical data related to the U.S. business economy. NAICS recognizes 20 industry sectors, which are separated into 99 subsectors, 312 industry groups, and over 1000 industries, each of which is assigned a six-digit code.

Contracting officers then must classify each and every solicitation by an industry-level NAICS code that, by their determination, describes the principal purpose of the product or service. Accordingly, a business that qualifies as “small” under one or more NAICS codes may not qualify under others. As one might imagine, the procuring agency must carefully consider each NAICS code designation. Erroneously assigned codes constitute valid ground for bid protests, which can be costly for the government.

However, NAICS code selection can be a subjective endeavor, and can significantly affect the companies eligible. McVay (2009) provides an example which would be comical in its banality if not for its real-world implications. He writes that “if a contracting officer decides to set aside a contract for paperboard boxes, should he categorize the boxes as ‘Setup Paperboard Boxes’ (NAICS code 322213), which has a size standard of 500 employees, or as ‘Folding Paperboard Boxes’ (NAICS code 322212), which has a size standard of 750 employees?” (p. 185).

Small Business Representation in Federal Contracting

Figure 2 depicts FY 2015 federal contract obligations by industry sector. The first thing to notice is that federal procurement is highly concentrated by sector, with manufacturing; professional, scientific, and technical services; construction; and administrative support accounting for more than 80% of procurement.

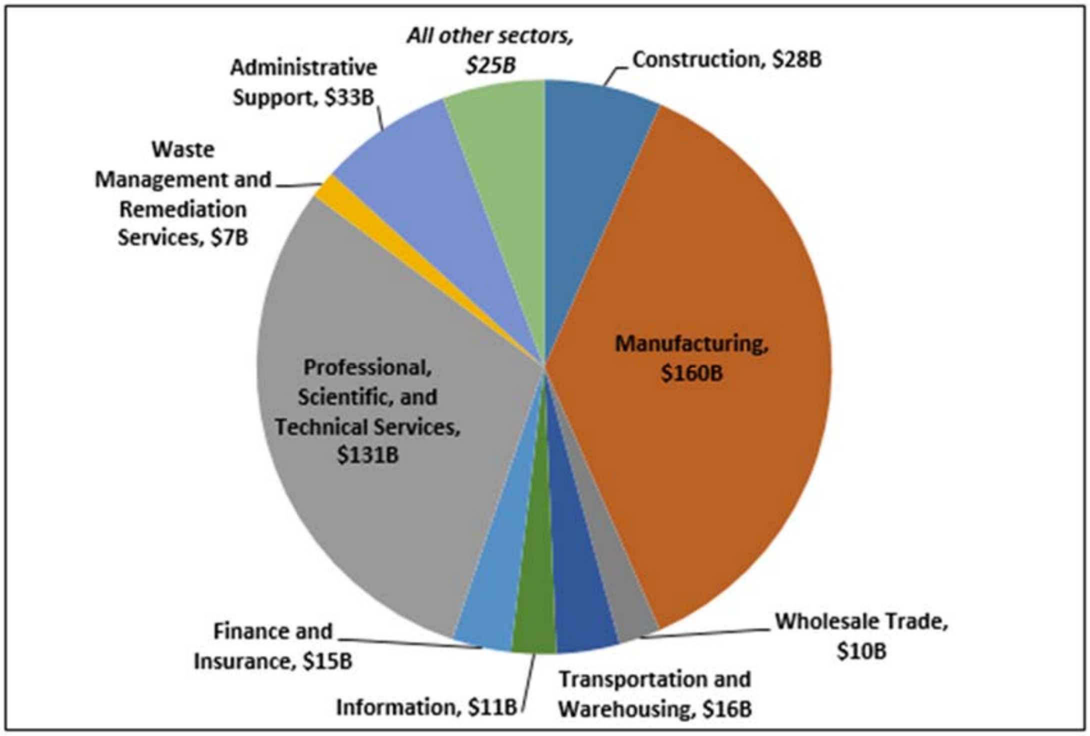

Figure 2. FY 2015 Total Federal Contract Obligations by Industry Sector
(Analysis of FPDS Data)

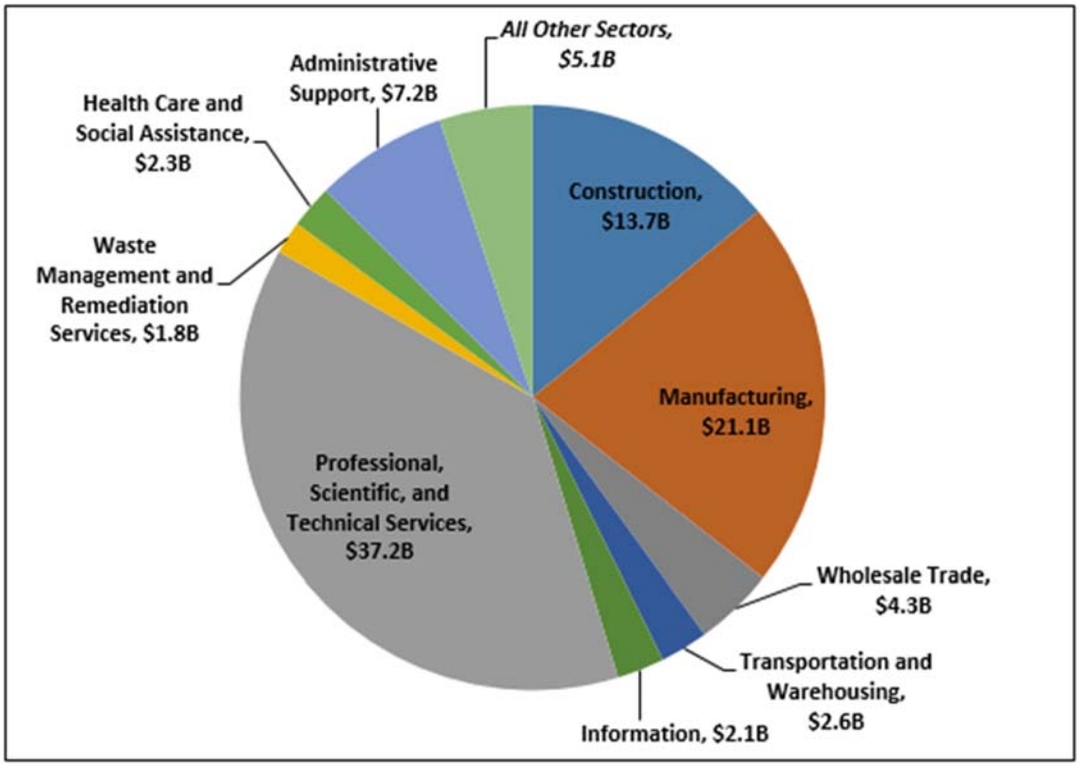

Figure 3. FY 2015 Small Business Federal Contract Obligations by Industry Sector
(Analysis of FPDS Data)

Figure 3 depicts small business federal contract obligations by industry sector. Though the same four sectors dominate, their relative sizes differ significantly. Two sectors, construction and professional, scientific, and technical services account for relatively larger pieces of the small business pie; manufacturing accounts for a noticeably smaller piece. Figure 4 compares the relative sizes of the four major sectors in each of the two procurement spaces (i.e., small business and "other than small business").

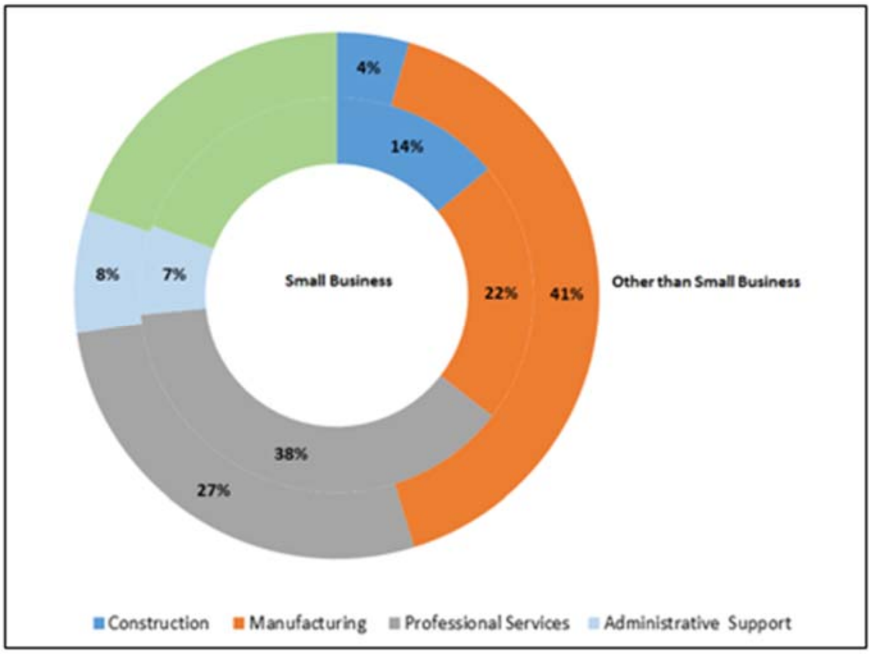

Figure 4. Sectoral Composition, Small Business vs. Other Than Small Business, Percentage of FY 2015 Action Obligations
(Analysis of FPDS Data)

The Small Business Potential

Table 3 depicts the relationship between total federal procurement within each sector and the small business share within that sector. The table shows, for example, that 4% of all federal contract obligations fall within the transportation and warehousing sector. Of that 4%, or $16 billion in total federal contract obligations, 17%, or $2.6 billion, is obligated to small business.

Increasing the small business opportunities within the 10 sectors where federal procurement is below 1% of the total will have minimal impact on the overall small business share, especially given that in eight of these “minor” sectors, small business is already well represented. In terms of federal procurement, small business dominates the agricultural sector, with 76% of all dollars (in FY 2015) awarded to small business, but this figure translates to only $318 million.

The table makes it clear that any effort to significantly increase the small business share of federal contracting dollars must be directed within the first four or five sectors, where the overall level of federal procurement is relatively high. However, there are challenges in this regard. In the construction sector, for example, nearly half (47%) of all contracting dollars already flow to small business, a figure well above SBA’s government-wide small business contracting goal of 23%. As for manufacturing, the federal government spends the bulk of its contracting for manufacturing dollars in highly-specialized industries such as aerospace and military manufacturing. These industries require extensive capital investment, a large operating footprint, and far-reaching logistics networks.

Table 3. Federal Procurement by Sector and the Small Business Share, FY 2015
(Analysis of FPDS Data)

Sector	Total contract obligations	Small business share
Manufacturing	37%	13%
Professional, Scientific, and Tech Services	30%	29%
Administrative Support	8%	23%
Construction	7%	47%
Transportation and Warehousing	4%	17%
Information	3%	23%
Finance and Insurance	3%	3%
Wholesale Trade	2%	42%
Waste Management and Remediation	1%	26%
Healthcare and Social Assistance	<1%	37%
Education Services	<1%	24%
Retail Trade	<1%	37%
Other Services	<1%	27%
Real Estate and Rental and Leasing	<1%	43%
Agriculture, Forestry, Fishing, and Hunting	<1%	76%
Accommodation and Food Services	<1%	20%
Utilities	<1%	9%
Mining, Quarrying, Oil and Gas Extraction	<1%	58%
Arts, Entertainment, and Recreation	<1%	67%

Growth of Small Business in the Professional Services Sector

It seems, then, that the potential for greater small business procurement lies primarily in the professional services sectors and, to a (far) lesser extent, the administrative support and transportation and warehousing sectors. Figure 5 depicts small business trends in the four major sectors over that last decade.

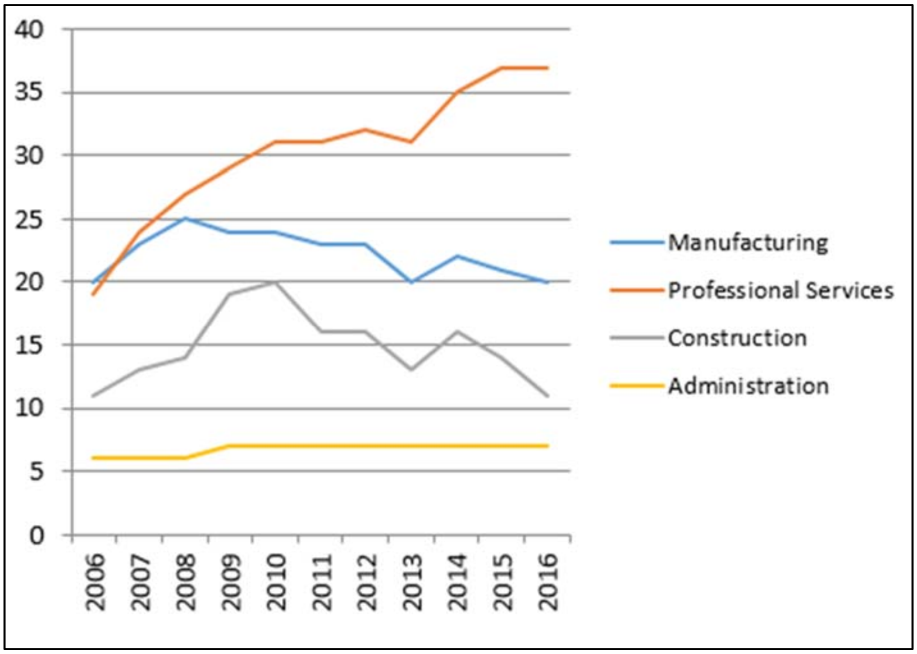

Figure 5. Small Business Share (Action Obligations in $Billions) of Federal Contract Dollars in the Four Major Sectors
(Analysis of FPDS Data)

In terms of small business representation, the graph indicates steady growth within the professional services sector. It is of note that these trends are not necessarily representative of federal procurement in general. Figure 6 shows trends in federal contracting, excluding small business, in the same four sectors.

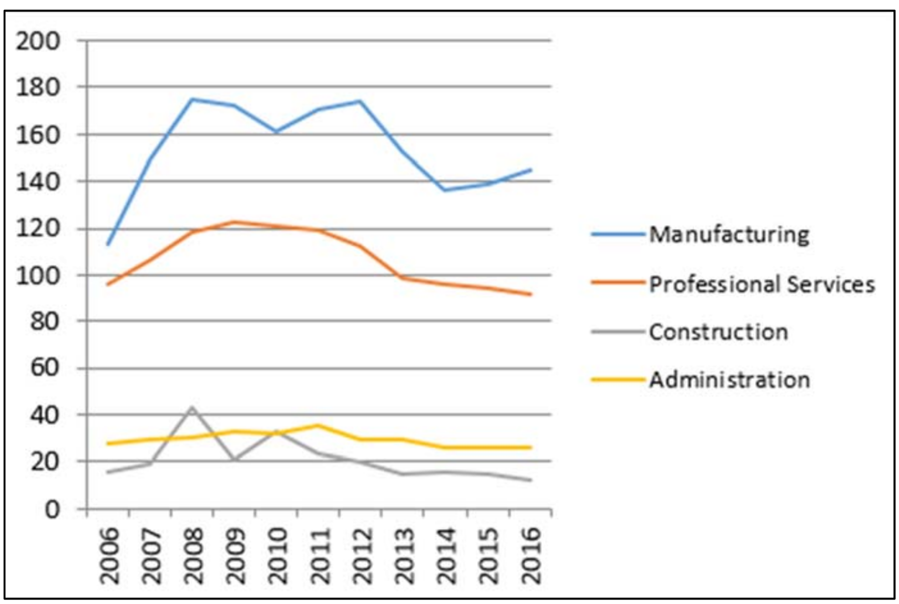

Figure 6. Federal Contracting (Action Obligations in $Billions) in the Four Major Sectors, Excluding Small Business
(Analysis of FPDS Data)

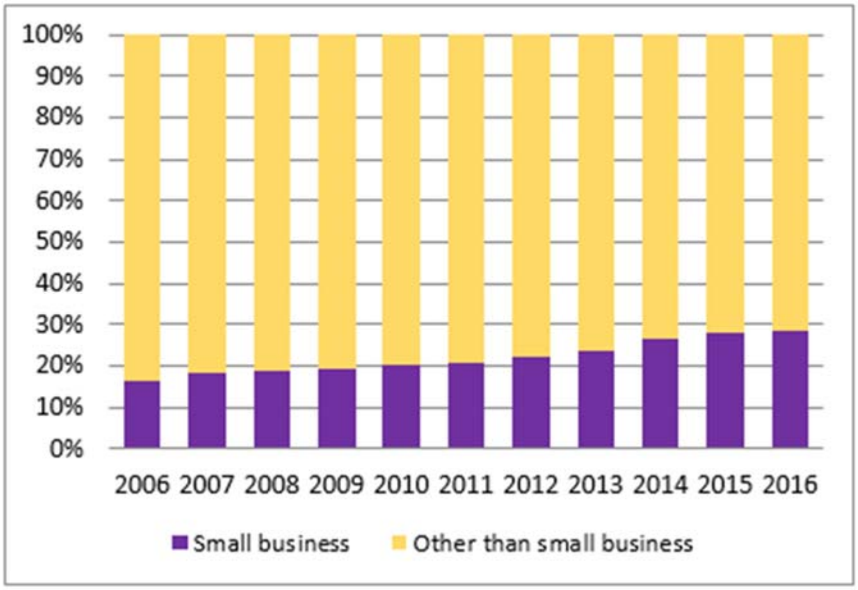

Figure 7. Small Business Participation in Federal Contracting, Professional Services Sector, Percentage of Action Obligations, $
(Analysis of FPDS Data)

It is clear that small business has lost ground in the construction and manufacturing sectors, but has gained steadily in the professional, scientific, and technical services sector. Figure 7 shows the growth of the small business share of federal contracting dollars in the professional services sector over the last decade, from 15% in 2006 to 29% in 2016.

As Table 3 indicated, within the context of federal contracting, there are very few industry sectors capable of providing significant new opportunities for small businesses. Accordingly, and as recent trends suggest, SBA set-aside policy will have the effect of concentrating more federal contract spending into the growing professional services sector.

Unintended Consequences

In this section, we highlight the unintended consequences that derive from concentrating small business contract spending into the professional services sector. For small firms, these include uneven and unsustainable growth and significant barriers to entry; for government, unintended consequences take the form of contracting and economic inefficiency.

In an effort to contextualize our findings, we present the perspectives of professional services providers (small and mid-size) as well as government officials. In both cases, their identities have been anonymized in order to solicit candid responses.

It should be noted upfront that all of the participants conveyed a favorable view of the *concept* of small business set asides. One small firm remarked that its view of set asides was

> absolutely positive. … It allows us to compete on a more level playing field. I think it's been a great program. You look at the numbers of small businesses in the United States, [and] you hear time and time again that so much of the income and GDP comes from small businesses.

Another noted that "if you didn't have set asides, then you wouldn't be able to seed companies." However, when it came to the specific content of set-aside policy and its implementation, perspectives were more nuanced.

Uneven and Unsustainable Growth

Set-asides may induce the small business to grow more rapidly than it otherwise would. This growth may be uneven and unsustainable. Because the small business is not able to develop adequate depth in the provision of capabilities and other business functions in such short order, large contracts have the potential to overwhelm its infrastructure and capacity. This is an increasingly likely outcome given that small businesses are also being awarded both a higher number and greater percentage of large contracts in the professional services sector (see Figure 8), a trend that is not seen in small business procurement generally. In 2006, small business received approximately 5% of contracts over $25 million; by 2016, the figure increased to over 16%.

One mid-size business with whom we spoke offered the following perspective:

> Right now, [government agencies] are just managing against numbers. They're managing against quotas and objectives. I think that what's needed is a healthy step back to try to understand what is it we're trying to accomplish. I don't mind having small businesses get a priority for some prime contracts, but having a small business award that is a hundred million or two hundred million a year is just ludicrous. It's totally ludicrous.

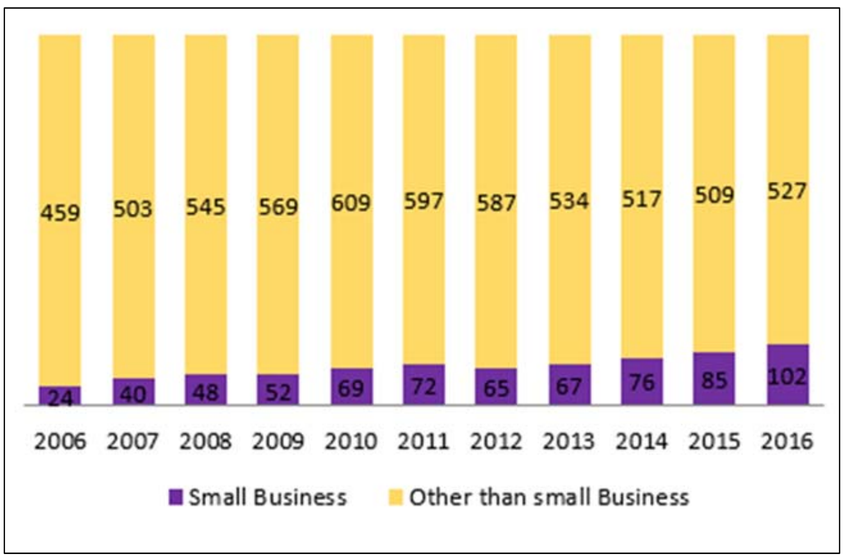

Figure 8. Number of Large Contracts (> $25 Million) Awarded Annually in the Professional Services Sector
(Analysis of FPDS Data)

As successful small businesses increase their annual revenues, graduating from certain NAICS codes, they must look to compete for government set-asides in other industries, often those whose size standards are expressed in number of employees. There are three NAICS codes in the professional services with size standards expressed in number of employees: research and development in biotechnology (1,000); research and development in the physical, engineering, and life sciences (1,000); and information technology value added resellers (1,000).

However, this transition may require that the small business reorient its business model, relinquishing the sought-after capabilities that made it successful in the first place. Clearly, this outcome represents a loss to both the firm and the government.

One small firm, whose yearly revenues recently began to exceed the 27.5 million size standard, had this to say:

> [In areas such as] software development, cybersecurity, [and] IT networking, we have to look to basically be a sub. We can't really compete for that work any longer, even [with regard to] our prime contract today … we can't re-compete for our own work there because of the NAICS code [size standards].

Indeed, this same firm decided to reorient its business model in order to pursue contracts in other NAICS codes:

> We're focusing now on other parts of our business where we do engineering services work, [which has] a higher NAICS code and research and development programs. [But] these potential prime opportunities … require a business shift for us as far as the talent that we have on board. All IT people aren't necessarily R&D people.

Another option, of course, is to compete in the full and open category alongside established mid-size firms and defense industry giants. Often, graduating small businesses are not well positioned to succeed in this environment. According to Representative Gerald Connolly (D-VA): "Innovative, high performing small businesses are becoming victims of their own success—graduating from small business programs only to find themselves in the untenable position of facing off against multi-billion dollar firms" (Weigelt, 2013).

Some small businesses may pursue yet another option: choose to limit growth and remain small to avoid disqualifying themselves for small business set-aside contracts. Rather than pursue growth and diversification so as to become independent and financially robust, they remain dependent on subsidized federal contracts to survive. These "permanent small businesses" may become quite adept in this environment over time. According to one small business executive:

> I met with another small business owner … and you won't believe this. He said "I'm in it for the nine years. I'm a retired army guy and I've also got a background so that I can be a [small disadvantaged business]. My intent is to grow it for nine years, make all the money I can and then let it die."

Needless to say, this outcome is antithetical to the SBA set-aside program's primary goal to encourage small businesses to hire more employees and grow.

Barriers to Entry

As discussed, SBA polices create market distortions by, in effect, mandating that federal agencies look increasingly to small business to fulfill their professional services requirements in order to meet SBA targets, thereby creating artificial demand for small businesses within this sector. As a result, there are more small businesses vying for a share of the overall spend, which has hindered contracting agencies' ability to effectively and efficiently contract for services. Agencies must spend more time reviewing more proposals from small businesses with which agencies may be unfamiliar. Complicating matters further is the shortage of experienced acquisition professionals. A retired senior Air Force contracting official summarized his perspective on acquisition personnel as follows:

> There is an obvious challenge when you take people who do not possess the depth of experience and you rush them into positions commensurate with

elders who have held 15 years' worth of experience before they came into the same position. There are some obvious challenges with experience level, education and training. There are institutions out there that are trying to tackle those challenges, but textbooks and classroom training can simply not replace repetition and experience.

In an effort to circumvent the lengthy solicitation process, government agencies have turned increasingly to multiple-award indefinite delivery/indefinite quantity contracts (MA/IDIQ), often in the form of Government-wide Acquisition Contracts (e.g., the GSA's OASIS and Alliant contracts) or single-agency multiple award contracts (e.g., the Air Force's NETCENTS). Total procurement obligations under multiple-award contracts exceeded $80 billion in 2011, double the amount in 2006 (Robinson, 2013).

Another reason that the government has turned to MA/IDIQs is to avoid bid protests—i.e., a challenge to the award of a contract, typically lodged by a competitor—which have increased significantly over the last decade from 1,352 to 2,561 in 2014 (GAO, 2015). In fact, the number of annual bid protests ticked up by 5% alone in 2014, an increase that is not insignificant, considering the overall decrease in procurement spending (Burton, 2015).

Often, agencies rely on two variants of a contract, one that is reserved exclusively for small business participation and one that is "unrestricted." Small businesses that are awarded MA/IDIQ contracts compete against other small businesses for individual task orders placed by government customers. These customers often view MA/IDIQ contracts as "one stop shops" that enable them to quickly and easily meet both their professional services needs and their SBA-negotiated small business goals.

But because MA/IDIQs tend to have relatively long periods of performance, often up to five years, and few "on ramps," the contracts tend to limit participation. In essence, they create a few winners, but many other small firms are shut out. A government contract officer with whom we spoke asserted that "SBSAs are giving small businesses work, but you have to be among the select few; there are some winners but there will be a lot of losers."

According to one small defense firm,

> There are 80,000 small businesses [capable of] supporting DoD and you've got [only] 129 of them on OASIS. And the Army, Navy, and Air Force have decided all of their services work is going to OASIS. How does that support the small business industrial base? It kills it. That to me, I think, is tied to the number of protests and I think its tied to shortages in contracting officers and agencies that are so tired of dealing with all the regulations that they're looking for an easy way out.

OASIS and Contracts Consolidation

In 2013, the GSA launched its One Acquisition Solution for Integrated Services (OASIS) in response to federal agencies' requests for a more efficient process by which to hire professional services contractors. OASIS is a family of seven separate Government-wide, MA/IDIQ task order contracts spanning 28 NAICS codes and six exceptions. There are two versions of each of these contracts: one that is unrestricted and another that is reserved for small business. The contracts are referred to individually as "pools." Each of the seven small business pools is designated by a size standard. For instance, "Pool 1" consists of 21 NAICS codes that share the $15 million size standard; Pool 4 consists of two NAICS codes, both in R&D, that share the 1,000 employee size standard. When issuing an RFP under the OASIS Program, only one contract version (OASIS unrestricted or OASIS Small Business) and only one pool can be solicited.

Because OASIS has no program ceiling and a relatively long period of performance—a five-year base and one five-year option—the vehicle allows government customers to make long term plans to meet their program requirements. In small business circles, however, OASIS has been the cause of much controversy and consternation. Over the last three years, over $1.3 billion in DoD contracts alone has been transferred to OASIS, causing the abrupt displacement of numerous small businesses whose contracts are now performed by a relatively small group of 136 OASIS SB awardees.

Ironically, firms that win these coveted MA/IDIQs may not view them all that favorably because they are required to, in effect, bid twice—once for the contract and again for subsequent task orders—a process that can be onerous and expensive, especially for a small business. And, ultimately increasing overhead rates, that will be passed on to government customers.

One small firm executive categorized MA/IDIQ contracts as a "serious money drain," and stated that

> we shy away from those [MA/IDIQ contracts] tremendously. Multiple reasons. One reason is that it runs up B&P [bid and proposal] costs. You're in proposal mode constantly. Also, we've seen most of those contracts go back to the incumbents' time and time again. [And with] MA/IDIQs, there's no protest. It's not a friendly place for us to play.

MA/IDIQ contracts are not often structured to facilitate a small firm's growth. One firm with whom we spoke used to provide customized IT solutions through the Alliant GWAC. The firm noted that it had been "very successful on that contract." However, by the end of the contract's period of performance, the company had exceeded the $27.5 million size standard. According to the firm,

> We were no longer able to use that vehicle with which we were very successful. And there was no alternative. They didn't allow you on to what you might call the unrestricted, or the large business contract. They just said you're out, as if you had never won.

This firm's vice president noted that its revenues in FY 2014 and FY 2015 stood at $82 and $84 million, respectively. He stated that "this year we will close at $50; next year we will probably close below that."

To be sure, MA/IDIQ contracts can offer benefits to small business awardees that traditional contracts cannot. According to 13 CFR 121.404 "If a business is small at the time of offer for the Multiple Award Contract, it is small for each order issued against the contract." Moreover, where a concern grows to be other than small, the procuring agency may exercise options and still count the award as an award to a small business. Accordingly, a small business that exceeds the relevant size standard upon winning one or two task orders can continue to compete throughout the life of the contract, which may span five, or even ten, years.

Take, for example, Amyx, a small business founded in 1999. The firm averaged approximately $10 million per year in federal contracts between 2010 and 2013. The firm was one of the first awardees of the OASIS Small Business contract (Pool 1) when it was launched in 2013. In January of 2017, Amyx was awarded its fifth task order under Oasis valued at $189 million over five years. During the same time, Amyx was awarded other large, high-profile, contracts by the DLA. Despite having exceeded the relevant size standard, Amyx will continue to be able to compete for task orders in Pool 1 ($14 million size standard) over the course of the next seven years (Thompson, 2015).

To some, this is seen as patently unfair—as evidence that MA/IDIQs in particular, and SBA policy generally, favor a small cadre of successful firms at the expense of a much larger group that feels "shut out" from some of the federal government's most lucrative contracts. However, permitting "mid-sized" firms to compete for small business task orders under MA-IDIQs might be viewed as an apt retort to the criticism that MA/IDIQs fail to facilitate firms' growth. What is clear, however, is that the consolidation of contracts into MA/IDIQs, especially GWACs, has widened the gulf between the haves and have-nots, the winners and the losers.

Contracting and Economic Inefficiency

Critics have asserted that the timing of small business awards—concentrated at the end of the fiscal year—represents agencies' attempts to meet their annual contracting goals and/or obligate remaining agency funds (see Figure 9). By taking advantage of set-aside policy to bypass lengthy sourcing, agencies are able to obligate their remaining funds quickly. One small business with whom we spoke provided the following perspective:

> You know that the fiscal year ends for the government in September 30. You also know that the federal government is not a business where they earn profit or a return on investment—their goal is to spend all of their money as fast as they can, so that they can continue to get the same level of funding. So when they get to around the August timeframe, they realize how much money they have left. If there are some things that they are interested in and a small business is able to bring that value to them, they can quickly put a sole source out and get rid of that money.

Needless to say, efforts made to spend funds quickly likely fail to maximize taxpayer value, representing yet another unintended outcome of set-aside policy.

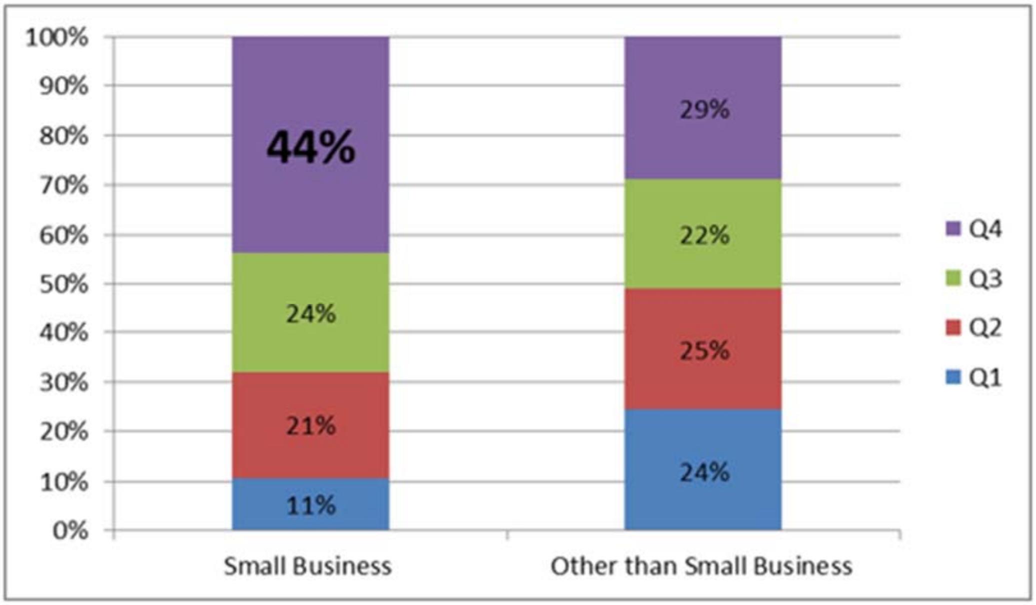

Figure 9. Timing of Contract Awards ($), 10-Year Average, 2007–2016
(Analysis of FPDS Data)

NAICS code selection can be another source of inefficiency. With the increasing pressure to meet the small business set-aside goals, agencies, on occasion, use an inappropriate NAICS code. In fact, the term "code shopping" has emerged to describe agencies' attempts to use NAICS codes with larger size standards, ostensibly in an effort to attract larger small business, with enough staff to meet user requirements, yet still meet their small business contracting goals. Because NAICS codes within the professional services sector tend to be more open to subjective interpretation than codes in other sectors, and because professional services firms often provide diverse and varied services under a single contract, there is greater potential for code shopping within the growing professional services sector.

Set-aside policy also creates the potential for significant economic inefficiency within the professional services sector. As one mid-sized business executive observes,

> The government is always prone, when it hears about any inequities, to create more categories, more numbers, more demographic barriers, or segments. We continue to see the proliferation of size standards and demographic categories. At some point you have to ask, does the creation of these categories become counterproductive? By segmenting the industry space, do you force turbulence? Do you force unnecessary churn in the market?

With the current set-aside policy, mid-size and large professional have fewer opportunities. A Center for Strategic and International Studies (CSIS) study concluded that mid-size firms (these were defined as firms which are too large to be categorized as small but had less than $3 billion in total annual revenue) were being "squeezed" out of DoD contracts by both large and small contractors. CSIS found that from 1999 to 2009, the share of DoD contracts awarded to small businesses increased (from 17.0% to 17.4%) and to large firms increased (from 47.0% to 53.7%), while the share awarded to these mid-size firms decreased (from 36.0% to 28.9%; CSIS 2012).

Regarding the concentration of small firms in the professional services sector, a mid-sized defense firm with whom we spoke offered the following perspective:

> It doesn't make sense to have all of our services business go to small business, because quite candidly, I'm not sure what that really does for the nation. To all of a sudden have these body shops that are now small businesses … well, these businesses often struggle.

The firm commented that its defense customers began to turn to small businesses in 2012 and 2013, when the government placed renewed emphasis on meeting set-aside goals. The firm noted that

> as our contracts came up for re-compete, our customers were very up front about it. They said, "Hey, we don't want to go small business, we don't think it makes any sense. But we are being forced to go small business." So we saw a very significant squeeze. A contract may have had 20 or 30 of our people and now it's up for re-compete; all of a sudden, it's going to be a small business contract.

The intent of the small business set-aside programs is to grow small, and, in many cases, disadvantaged businesses to become competitors for additional contracts. As the awards grow in size, the small firms are forced to team with a larger firm as a sub-contractor. When these companies exist simply as shells or as "pass-throughs," they fail to meet the objectives of the SBSA program. According to a senior defense official:

> Anytime the small business is working in name only, this causes the DoD to simply pay a mark-up fee of 2% to 8%. This is detrimental and unfair to the taxpayer when we blindly give work to smalls, and this happens a lot because the government focuses on excessive amount of small businesses, that's when you get the shell companies to emerge.

Findings and Recommendations

Small business procurement is not evenly distributed across industry sectors; rather, it is increasingly concentrated in a few sectors, including, most notably, the professional services sectors. Consequently, small business set-aside policy, in its current implementation, yields negative consequences for small business and for government.

Findings

- Often, agencies' small business contracting goals must be met by "overspending" in the professional services sector, which creates artificial demand for small professional services providers, while "squeezing out" established, and often better qualified, mid-sized and large firms.
- SBA policies have clearly facilitated the growth in the award going to small businesses, however uneven or, at times, unsustainable. However, the rationale or methodology for developing the goals, if one exists, is not well understood. Additionally, since current revenues form the basis of future size standard determinations, many growing industries within the professional services sector will be subjected to upward revisions, thereby raising the barriers to new entrants, perhaps hindering innovation.
- When small professional services providers receive larger contracts, their growth trajectory is accelerated, such that they are often no longer eligible for set-asides; these providers frequently lack the capability and infrastructure to compete under free and open competition.

- Agency set-aside goals encourage a trend whereby small business must subcontract with a large business that will perform work in areas where the small business has limited capabilities. In some instances, the small business acts as "a pass-through" that offers limited or even negative value to government.
- The proliferation of small firms in the professional services sector, combined with a declining acquisition workforce, has fueled increased reliance on multiple award contracts, which favor a select group of small firms, but "shut out" the majority.
- In an effort to meet small business goals, agencies may resort to "code shopping" in an effort to obtain the best of both worlds: the services of a larger, more qualified, "small" business and credit towards their small business contracting goals.
- When government agencies need to obligate funding quickly, they turn to small business contracting, a practice that may not obtain government best value.
- The complex regulatory environment, especially within the DoD, SBA size standards (revenue or number of employees) for small business that vary across more than one thousand industries, in addition to goals for prime and subcontracting that differ by agency and type of small business (e.g., minority-owned, women-owned, etc.) all require a large bureaucracy that is maintained at taxpayer expense.

Based on our analysis of FPDS data and our examination of the unintended consequences that derive from set-aside policy, we offer the following recommendations.

Recommendations

Set Realistic Numeric Agency Goals

The Small Business Administration should develop an understandable, rational, and transparent, methodology to establish numeric agency small business goals. Consideration should be given to the development of a single goal, that would include both prime and subcontract dollars; adjusting the calculation and grading methodology to account for small business firms participating at all tiers of the agency contracts.

Encourage the Best Small Businesses to Grow

Small business set-aside program must be structured to encourage the best firms to grow. To accomplish this, there must be enough opportunities for these firms to compete when they graduate.

Improve Data Gathering and Program Metrics

It is impossible to understand the full impact of any program without reliable data and metrics. Currently, the small business set-aside program focuses on achieving the numerical goals for small business contracting. However, it is difficult to assess the costs that this program may impose, and how successful the program is in achieving the program's overall objectives (e.g., job creation, innovation, growth, etc.), that is, the program's outcomes.

Use Set-Asides for Acquisitions Only When Small Business Can Handle Them

When given the appropriate contracts, small businesses can successfully perform as, or more, efficiently than a large business. The key is selecting the suitable opportunities that are within the scope and scale of the small business, so that selecting a small business prime does not create a risk of poor performance. Small business set-asides are suitable when they enable a firm to grow, but do not overwhelm its infrastructure or capabilities. Awarding a contract to a firm that is beyond its capacity will cause the company to have difficulty with that work, and may cause it to fail. Agencies should refrain from awarding large contracts that approach or exceed the industry size standard. Large contracts have the potential to overwhelm small firms' infrastructure and capabilities. Moreover, these contracts prematurely hasten a small firm's growth trajectory, often to point where the firm is no longer eligible to receive set-asides.

Review NAICS Code Thresholds

The SBA has defined these size standards for groups of industry. When these groups are too broad, the codes can provide enough ambiguity so that an inappropriate code (and as a result size standards) can be used. This results in an inappropriate set of firms that are subsidized, and the intended recipients are not eligible. These thresholds must be clear and unambiguous.

Review the Use of Multiple Award/IDIQ Contracts

Reliance on IDIQ vehicles as convenient tools for flexible contracting has helped reduce the transaction costs associated with many programs. However, IDIQ contracts have the potential to limit overall competition since potential vendors are preselected. Small businesses that are not awarded IDIQs in their industry are effectively "shut out" of some of the federal government's most lucrative contracts. Those fortunate enough to be awarded IDQs face high bid and proposal costs (relative to traditional contract solicitations) in that they must bid on the initial contract and then again for each individual task order placed under that contract). For small businesses with limited means, these costs may prove prohibitive, creating barriers to entry and constraining innovation.

Conclusion

As Milton Friedman once remarked, "One of the great mistakes is to judge policies and programs by their intentions rather than their results." Current federal policy with respect to small business set-asides was formed, and is implemented, with the best of intentions. However, as with many policy initiatives, there can be unintended consequences. The government must strike a balance that encourages the growth of innovative small businesses while ensuring that its contracting needs are met in a way that is responsible, effective, and efficient. Small business set-aside policy, in its current implementation, may not strike the optimal balance.

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