Increasing the Capacity of the Nation's Small and Disadvantaged Businesses (SDBs)

FINAL REPORT

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Submitted to: **The Congressional Black Caucus Foundation**

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Executive Summary

EuQuant (formerly Boston Research Group) was commissioned by the Congressional Black Caucus Foundation to conduct a comprehensive study of the Small Disadvantaged Business (SDB) Program run by the U.S. Small Business Administration. The report seeks to increase the national and global competitiveness of SDBs by offering recommendations that are designed to increase their capacity and success in federal procurement and in corporate supply chain relations. The primary recommendation is that the $750,000 personal net worth ceiling of the SDB program should be adjusted so that participants can build greater capacity. By building greater capacity, SDBs are able to operate more successfully in the public and private sectors. Their greater success adds significant value to overall economic output and generates jobs, income, and wealth in the general economy and especially in underserved communities.

Background and Purpose

- The government's Small Disadvantaged Business (SDB) Program was established to help mitigate the effects of discrimination on the performance of businesses owned by minorities and other socially and economically disadvantaged individuals.

- This comprehensive report assesses the impact of the SDB Program on minority-owned businesses and examines the contribution of SDBs to national output and employment.

- A major section of the report is devoted to exploring how the SDB Program's $750,000 personal net worth (PNW) ceiling affects SDBs.

- After determining that the PNW ceiling is too low and that it adversely affects the operation of SDBs, new program changes are proposed.

- The recommendations are designed to increase the capacity of SDBs so they will become more competitive in federal procurement and in corporate supply chains.[1]

- The results are based on an examination of 47,254 Small Business Concerns (SBCs)[2] listed with the government's Central Contractor Registration (CCR) in 2006.

What the Reader can Expect

The report has thirteen sections. These sections describe the current status of minority-owned businesses, document the critical importance of government contracting to minority business viability, and examine the plight of more than 10,000 minority-owned SBCs that are listed in the CCR but have never participated in the SDB program. The report considers how the U.S. Supreme Court Adarand Decision has changed the SDB Program. It measures the impact of the SDB Program on minority business performance and analyzes how the $750,000 PNW ceiling has affected SDB capacity. Finally, it estimates the influence of the SDB Program on national output and employment and it analyzes where minority and non-minority-owned firms are located in relation to the most distressed areas of central cities.

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[1] As used in this report, capacity is synonymous with the three-year average revenue of a firm.

[2] A Small Business Concern (SBC) means any for-profit business that meets the industry and employment size standards as determined by the Office of Small Business Standards of the Small Business Administration (See Federal Acquisition Regulation FAR 19.101, at: http://acquisition.gov/far/current/html/FARTOCP19.html). This report does not examine SBCs that register with CCR as Women-owned Small Business Concerns, Veteran-owned or Disabled Veteran-owned Small Business Concerns.

Findings[3]

In 2006, the SDB Program had an economic impact of $5.5 billion on U.S. final demand and created over 124,000 jobs.

Minority-owned small businesses also contributed to the economic development of distressed central cities. In 2006, 31% of minority-owned businesses listed in CCR were located in high poverty areas of central cities as compared to 24% of non-minority-owned companies.[4]

In some central cities a very high percentage of minority-owned businesses were located in high poverty areas: In Baltimore (69%), Philadelphia (60%), Detroit (50%) and Boston (48%).

Despite the significant contribution that minority-owned businesses make to the U.S. economy, they still encounter large disparities in private sector business transactions. Consequently, they depend more heavily upon government contracting because access to government contracts is usually more equal than is access to private sector opportunities. While minority-owned businesses comprised 18% of all U.S. small businesses, they made up 35% of the 47,254 small businesses listed in CCR in 2006.

Between 2004 and 2006 the SDB program had a significant effect on the performance of SDB certified firms. The average revenue of SDBs was $2.8 million greater than the average revenue of identical firms that did not participate in the SDB Program.

SDBs experienced an annual disparity in revenue of $0.9 million in comparison to non-minority-owned small-business concerns with similar characteristics.

There were 10,513 minority-owned small businesses listed in CCR in 2006 that had never been SDB certified. These firms experienced the greatest disparities of all small businesses that sought federal government contracting.

The $750,000 personal net worth (PNW) ceiling of the SDB Program has not been adjusted for inflation in nine years. Therefore, the current real value of the ceiling is $558,070. Yet innovations in corporate supply chains and the increasing use of contract bundling in government procurement require SDBs to have greater capacity.

The capacity of SDBs and the personal net worth of their owners is closely related. When capacity increases by 10%, PNW increases by 4%. Therefore, if the PNW ceiling is too low, it is impossible for SDBs to reach their optimum capacity. In a marketplace free of discrimination we estimated that the average capacity of SDBs would be $4.1 million. The current PNW ceiling prevents SDBs from achieving this average capacity.

A PNW ceiling that is set too low causes other economic hardships. For example, in February of 2007 seventeen firms were graduated out of the Georgia Department of Transportation Disadvantaged Business Enterprise Program when an audit revealed that their PNW surpassed the $750,000 ceiling. We interviewed the owners of these firms and tracked their monthly financial performance. The owners felt that they were being penalized for being successful and they complained that very few corporations solicited or engaged their services after they were de-certified. They also stated that the low PNW ceiling had not allowed them to build sufficient bonding capacity to compete successfully as prime contractors. During the first five months of 2007, their average monthly revenue decreased by 45% in comparison to 2005 and 2006.

Many large businesses are incorrectly registered in CCR as small businesses. In a recent Congressional hearing, SBA Inspector General Eric Thorson stated that, "The number 1 management challenge facing the SBA is that large firms are receiving small business contracts and federal agencies are receiving credit for these awards."[5] This report identified 442 companies registered as small businesses that exceeded the small-business size standard for their industry. In 2006, the average revenue of these 442 companies ($172 million) was forty-four times larger than the average revenue of legitimate small business concerns.

[3] The study used regression analysis and decomposition analysis extensively to explain the differences in performance between minority-owned firms that never entered the SDB Program (10,513), active SDBs (6,758) and other small business concerns that were not minority-owned in 2006 (27,087). A multivariate propensity score matching procedure was used to measure performance differences between firms with identical characteristics that were SDBs and non-SDBs.

[4] High poverty areas are defined as census tracts where poverty was 20% or greater in 2000.

[5] Chapman, Lloyd. 2006. "SBA Reauthorization Lacks Provisions to stop Fraud and Abuse." American Small Business League, July 20, 2006:
Accessed at: http://www.asbl.com/showmedia.php?id=275

Recommendations

1) **Increase the PNW ceiling for construction industries to $979,000, for manufacturing industries to $1,043,000 and for professional and scientific service and IT services industries to $1,026,000. The PNW ceilings should be adjusted annually for inflation. In addition SDBs that exceed the PNW ceiling should be given a two year transition period during which they remain eligible to participate in the SDB Program.**

   Rationale for this recommendation

   First, the current PNW ceiling has not been adjusted for inflation since it was established in 1998. If adjusted, the current PNW would be $977,560. Second, the SDB Program was established to help mitigate the effects of discrimination. But it is very difficult for SDBs to achieve the capacity they would be expected to have in a non-discriminatory market because the PNW ceiling is too low and capacity and PNW are closely related. Third, the PNW regulation assumes that "one size fits all." Therefore, only one PNW ceiling has been set for all industries. This contrasts with small business size standards that are set for each industry. The single PNW ceiling does not take into consideration the level of capitalization required by different industries.[6] Finally, when SDBs are "graduated" from the program unexpectedly because of the PNW ceiling, they face significant short-run decreases in revenue. For example recent data from the Georgia DOT indicated that when minority-owned firms were "graduated" from the DBE program because of an audit of PNW, their monthly revenue decreased by 45% during the first six months following their exit.

2) **The SBA should establish race-neutral monitoring procedures for small minority-owned firms that are not SDB certified.**

   Rationale for the recommendation

   First, it is important to know whether minority-owned firms have fair access to corporate supply chains and government procurement in the absence of SDB mandates. Results of this study indicate that they do not. For example the 10,513 minority-owned small businesses listed in CCR that were not SDB certified in 2006 experienced the largest disparities in government procurement awards and supply chain utilization among all CCR firms. Second, it is important to know why so many minority-owned businesses are not SDB certified. Some owners have indicated that the costs and paperwork involved in certification are deterrents while others maintain that the benefits of the program have been greatly reduced over time. A revision should be made to Standard Form 295 (Summary Subcontract Report) by including a category to record the utilization of minority firms that are not SDBs. Additionally, improvements should be made to the way that corporations and government agencies report subcontracting data.

3) **Reauthorize all preferential procurement benefits of SDB status including Price Evaluation Adjustment (designed to assist SDBs as prime contractors), Subcontracting Evaluation Factors and Monetary Subcontracting Incentives (designed to increase SDB subcontracting opportunities).**

   Rationale for the recommendation

   First, SDBs add significant value to national output and employment. In 2006 SDBs added $5.5 billion to U.S. final demand and created 124,000 jobs that would not have existed without the program. Second SDBs, in comparison to non-SDBs, add significantly to economic opportunity in high poverty areas of central cities. Therefore by reinstating SDB procurement incentives, the goals of the HUBZone Program will be reinforced.[7] Third,

[6] The research team was unable to determine why the initial PNW ceiling for the SDB program was set at $750,000 and we did not have access to PNW data for non-SDBs. Therefore, we could not determine the industry specific PNW for all small businesses; but only for SDBs. As a result, we had to use the current PNW ceiling as our starting point for making an adjustment.

[7] If enacted, H.R. 1873, Sec. 214 would provide financial support to conduct of a study on the "feasibility and desirability" of providing financial incentives to contractors for meeting subcontracting utilization goals. PEAs allowed SDBs to receive a price benefit of up to 10% in specified industries. They expired in 2004. The HUBZone Empowerment Contracting

SDBs still face significant inequality in business transactions. For example, SDBs experienced an annual disparity in revenue of $0.9 million in comparison to non-minority-owned small-business concerns with similar characteristics. Finally, the procurement benefits are a major incentive for participating in the SDB Program.

4) Existing regulations that penalize large businesses for self-certifying as small business concerns (SBCs) should be enforced more vigorously and new penalties should be established. Additionally, the SBA Inspector General should audit the CCR annually to identify and penalize firms that are inappropriately self-certified as SBCs.[8]

Rationale for the recommendation

Inaccurate self-certification has been cited as a growing problem that is adversely affecting small business opportunity. This report identified 442 companies, that exceeded the small-business size standard for their industry, registered as small businesses. The average revenue of these firms was $172 million, which was forty-four times larger than the average revenue of legitimate small business concerns.

5) Additional studies are needed to further illuminate factors that may enhance the competitiveness of SDBs. These additional studies should examine:

- What happens to firms following their exit from the SDB Program;
- Ways of improving the global competitiveness of SDBs;
- The extent to which government procurement dollars are shifting from SDBs to other CCR groups;
- The relationship of PNW and firm capacity for non-minority-owned firms;
- The impact of the PNW ceiling on the ability to secure bonding, financing and supply chain opportunities; and, monitor the performance of minority-owned firms that are not-SDB certified.

Program is part of the Small Business Reauthorization Act of 1997. It is designed to stimulate economic development and create jobs in hard-pressed urban and rural communities. Contracting preferences are given to small businesses that are located in a HUBZone and that hire employees who live in a HUBZone.

[8] House of Representative Bill H.R. 1873: "Small Business Fairness in Contracting Act" passed the House on May 10, 2007 and has been sent to the Senate for consideration. Sec. 301-303 of the bill contains language specifying penalties for large businesses that fraudulently certify as small business concerns.