

The Government's Role in Aiding Small Business Federal Subcontracting Programs in the United States

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The Government's Role in Aiding Small Business Federal Subcontracting Programs in the United States

A Working Paper by

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Historically, small businesses in the United States have received a share of federal procurement dollars not quite commensurate with their relative importance in the U.S. economy. While 99.7 percent of all employer firms are small, they receive about 23 percent of direct federal procurement dollars and almost 40 percent of subcontracting dollars. While subcontracting has been a part of the federal procurement framework, it has not received the same focus and attention as the prime contracting program.

The purpose of the paper is fourfold. First, it discusses the importance of the small business sector to the overall economy. Second, it lays out the policy framework for the federal government's involvement in requiring "other than small" federal prime contractors to subcontract with small businesses. This policy discussion focuses on the period from 1958 to the present. Third, it examines the legislative and regulatory approaches that have been put forth to increase subcontracting opportunities for small businesses; and fourth, it discusses steps needed to improve the American small business subcontracting program to accommodate greater participation by these businesses in new and emerging global markets.

Major Recommendations

While procurement data are available in the United States, better data are needed to measure the true effectiveness of achieving procurement goals and policies. Current data cannot measure benefits from procurement. For instance, has discrimination been reduced or eliminated? Are local minority communities benefiting from government contract awards? A concerted effort must be made to produce a more comprehensive data set that will allow analysts to

more fully examine procurement policy toward small business. Ideally, new regulatory policy should be introduced alongside data requirements specific to the policy's goals and objectives.

The global economy is rapidly creating a need in America for greater flexibility in its small business programs. Public Law 95-507 was enacted in 1978 and has changed very little. Section 211 of this law is not flexible enough to account for new practices in the procurement marketplace. For example, the policy still assumes that the prime contractor is doing all of the work, whereas the reality is quite different—hence the need for more flexible policies.

The traditional contract theory of "privity of contract" has a valid place in contract law to prevent interference in the business relationship between prime contractor and subcontractor. The federal government argues that because it is in contract with the prime contractor and not the subcontractor, it does not have "privity" to enforce a claim by the sub against the prime. While public policies aim to protect small entities, "privity of contract" prevents any intervention by the federal government in resolving disputes, for example, concerning prompt payment or nonpayment between sub- and prime contractors. A more consistent implementation of Congress' intent and a more focused enforcement of set principles would be ideal in helping small subcontractors bring claims against larger primes. In other settings, mechanisms should be in place for the resolution of such disputes.

The federal marketplace is no longer national; it is international. International trade agreements between the United States and other countries have facilitated this transformation. On one hand, small

and small disadvantaged businesses are encouraged to participate in exporting goods and services, but on the other hand, the government continues to impose undue restrictions. This inconsistency harms small entities. For example, FAR Part 19.000(b) does not require prime contractors to submit subcontracting plans for federal contracts where the work is being performed outside of the United States, as previously established. Such policies are a disincentive to small business owners who are ready, willing, and able to compete in the international marketplace. Moreover, these policies may place American small businesses on an uneven footing vis-à-vis their foreign competitors. A model international small business subcontracting program should encourage the free flow of business.

Comment

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The Government's Role in Aiding Small Business Federal Subcontracting Programs in the United States

Major Clark, III, Chad Moutray, and Radwan Saade*¹

Abstract: Historically, small business in the U.S. has received a share of federal procurement dollars not quite commensurate with its relative importance in the U.S. economy. While 99.7 percent of all employer firms are small, they receive about 23 percent of direct federal procurements and close to 40 percent in subcontracting dollars. While subcontracting has been a part of the federal procurement framework, it has not received the same focus and attention as the prime contracting program. This paper is a cursory review of the procurement policy framework in the U.S. from 1958 to present, with a focus on the steps to improve the American small business subcontracting program in order to accommodate greater participation by these businesses in new and emerging global markets.

INTRODUCTION

The essence of the American economic system of private enterprise is free competition. Only through full and free competition can free markets, free entry into business, and opportunities for the expression and growth of personal initiative and individual judgment be assured. The preservation and expansion of such competition is basic not only to the economic well-being but to the security of this Nation. Such security and well-being cannot be realized unless the actual and potential capacity of small business is encouraged and developed. It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small business concerns in order to preserve free competitive enterprise, to insure that a fair proportion of the total purchases and contracts or subcontracts for property and services for the Government...be placed with small business enterprises... (The Small Business Act of 1953)²

Public Law 95-507 established the current small business prime and subcontracting programs to assist small businesses in obtaining procurement dollars from the U.S.

federal government. The government's federal small business prime contracting program

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was discussed in detail by Clark and Moutray (2004); this paper will focus on subcontracting.

Public Law 95-507 and Public Law 100-656 established goals for small business participation in the federal procurement process. In FY 2004, small businesses received contract awards of just over \$69 billion, or 23.09 percent of the nearly \$300 billion spent on federal prime contracts. This met the goal of 23 percent of prime contracts flowing to small firms that was established in the Small Business Reauthorization Act of 1997. Subcontracting is not part of this goal; the dollars spent with small firms through subcontracting are in addition to prime contract dollars. While final figures have not been released, it is estimated that small business subcontracting in FY 2004 reached \$50 billion from prime contractors (Clark 2005).

Table 1 shows the trends in federal subcontracting from FY 1985 to FY 2003. Over that time, small business subcontracting has hovered between 34 and 42 percent, with the FY 2003 figure at 38.2 percent. Yet the larger story is about increased opportunity for small firms as a whole. The total volume of subcontracts increased from \$63.8 billion in FY 1985 to \$119.1 billion in FY 2003. Behind those statistics are even larger percentage gains for small, disadvantaged businesses and women-owned small businesses.

The purpose of this paper is fourfold. First, we will discuss the importance of the small business sector to the overall economy. Second, we will lay out the policy framework for the federal government's involvement in requiring other than small prime federal contractors to subcontract with small business. This policy discussion will focus on the period from 1958 to the present. Third, we will examine the legislative and

regulatory approaches that have been put forth to increase subcontracting opportunities for small business; and fourth, we will discuss steps to improve the American small business subcontracting program in order to accommodate greater participation by these businesses in new and emerging global markets.

TABLE 1
U.S. Government Subcontracting Trends, FY 1985 to FY 2003
(Billions of Dollars)

Fiscal Year	Total Subcontracts	Small Business		Small Disadvantaged Business		Women-Owned Small Business	
		Dollars	Percent	Dollars	Percent	Dollars	Percent
1985	63.8	24.0	37.6	1.4	2.2	n.a.	n.a.
1986	61.9	24.3	39.3	1.5	2.4	n.a.	n.a.
1987	63.3	25.9	41.0	1.5	2.4	n.a.	n.a.
1988	69.9	27.0	38.7	1.7	2.4	n.a.	n.a.
1989	70.0	27.2	38.9	2.0	2.9	n.a.	n.a.
1990	68.8	27.3	39.6	2.4	3.6	n.a.	n.a.
1991	67.8	23.3	34.3	2.2	3.2	1.0	1.4
1992	58.7	22.3	38.1	2.5	4.3	1.1	1.8
1993	55.8	20.8	37.3	2.8	4.9	1.4	2.4
1994	57.5	22.0	38.3	3.2	5.5	1.5	2.5
1995	56.9	23.8	41.9	3.8	6.6	1.7	3.0
1996	61.2	25.3	41.4	4.1	6.7	2.1	3.5
1997	71.5	29.4	41.1	4.5	6.3	2.9	4.1
1998	67.8	27.4	40.4	4.2	6.2	3.1	4.6
1999	69.0	27.9	40.4	4.5	6.5	3.0	4.3
2000	77.0	30.6	39.7	5.2	6.7	3.6	4.7
2001	91.1	35.5	39.0	5.4	5.9	4.1	4.5
2002	98.0	34.4	35.1	5.5	5.6	4.7	4.8
2003	119.1	45.5	38.2	6.4	5.4	6.0	5.0

Source: U.S. Small Business Administration Annual Reports to the President

Note: In some cases, the percentages shown may reflect rounding error.

THE IMPORTANCE OF ENTREPRENEURSHIP

Policymakers of various ideologies now focus on the role of small business owners in generating employment and economic growth. A healthy and vibrant entrepreneurial sector is seen as a way for communities across the country (and for that matter, around the globe) to provide new economic vigor and increased stability in a dynamic world.

Such devotion to small firms is not unwarranted. Research continues to document the contributions of the small business sector to the overall economy. A recent analysis by the U.S. Bureau of Labor Statistics of employment changes between September 1992 and March 2005 showed that 65 percent of the net new jobs created during that timeframe stemmed from firms with less than 500 employees (U.S. BLS 2005). That finding is similar to data from the U.S. Census Bureau, which shows small firms generating 60 to 80 percent of net new jobs over the past decade.³ Moreover, much of the job creation comes from new start-ups in the first two years of operation (Acs and Armington 2003).

One of the reasons that small firms create so many net new jobs is their ability to innovate and find new niches that their larger counterparts do not. Baumol (2005) notes that innovation for many large firms consists of small, incremental steps that seek to improve upon existing products and processes, whereas small business “inventor-entrepreneurs” are often the only ones willing to take risks on their ventures. Some of these risks will yield “breakthrough innovations,” but most will not. This view of innovation is consistent with analysis by CHI Research, Inc. (2003). The authors find that small businesses produce 13 to 14 times more patents per employee than their larger counterparts, and that these patents are more likely to be cited in other patenting

applications. BJK Associates (2002) observe linkages between commercialized research innovations at universities with large budgets devoted to research and development and new firm formations that result in positive economic gains for the surrounding communities.

Of course such studies about the importance of small firms serve as complements to long-held perceptions about the small business owner in the American psyche. Knowledge of entrepreneurs as job generators and innovators only reinforces this viewpoint, but even without such research, there would be advocates for maintaining a strong, vibrant small business sector. To many, the small business owner is synonymous with small town America and an alternative to large multinationals.

The importance of small business is not just an American phenomenon. The Bologna Charter on SME Policies adopted on June 15, 2000, by more than 45 countries recognized the role played by small and medium-sized businesses by “recognizing the increasing importance of small and medium-sized enterprises (SMEs) in economic growth, job creation regional and local, and social cohesion” as part of its charter (OECD 2000). A just-published government-wide review of the procurement system in Canada went even further. Among other things, it found that “for those circumstances in which the best option for Canadians is to seek large contracts that may pose a barrier to small and medium enterprises, the Commodity Council will determine the best ways to protect the interests of small and medium enterprises and ensure that they have access either through consortia or through a percentage of subcontracts” (Lastewka 2005, p. 30). Japan, as early as 1970, enacted the Law on the Promotion of Subcontracting Small and Medium Enterprises to promote subcontracting with small and medium-sized

enterprises.⁴ A number of countries, however, have not yet identified the exact strategy to require public sector procurements to include provisions for small business subcontracting.

DEVELOPMENT OF SUBCONTRACTING POLICY, 1958-1978

In 1958, Public Law 85-563, which amended the Small Business Act of 1953, established a voluntary small business subcontracting program. Federal agencies awarded subcontracts to small businesses through a contractual clause in the Armed Services Procurement Regulation 7-104.36. This early mechanism was deemed by a 1977 Comptroller General report as being ineffective in promoting small business subcontracting (GAO 1977). This report served as one of several reasons for congressional legislation. In addition, the House Small Business Committee reported the following findings:

Small Businesses, and in particular, small businesses owned by the disadvantaged, have not been considered fairly as subcontractors and suppliers to prime contractors performing work for the Government. For example, military procurements comprise the largest single portion of the Federal purchase budget, yet in fiscal 1976, minority owned firms received only nine-tenths of 1 percent of military subcontracts (Committee on Small Business 1980, p. 52).

Whereas the initial amendments to the Small Business Act regarding small business subcontracting were voluntary, later revisions established much stronger requirements. Public Law 95-507 was enacted in 1978 stating that:

“[it] is the policy of the United States that small business concerns and small business concerns that are socially and economically disadvantaged have the maximum practicable opportunity to participate in the performance of contracts let by an Federal agency, including contracts and subcontracts for subsystems, assemblies, components, and related services for major systems.”⁵

Moreover, Section 211 of this act states that “no contract shall be awarded to any offeror unless the procurement authority determines that the plan of the proposed prime contractor offers such maximum practicable opportunity.”⁶ This section places an affirmative duty on the contracting officer to ensure full compliance.

Public Law 95-507 did not just focus on small business. The law shifted the federal focus from just small business to small businesses owned by minorities that were socially **and** economically disadvantaged. Prior to Public Law 95-507 minority businesses for the purpose of the SBA 8(a) program were defined as socially **or** economically disadvantaged small businesses. A congressional report acknowledged that the reason for the change from “or” to “and” was to prevent the increasing number of “front” companies—companies posing as minority businesses but actually controlled by nonminorities.⁷

Also, according to a former senior staffer on the House Small Business Committee, Thomas Trimboli, who wrote the draft language to Public Law 95-507, this change was a legislative drafting maneuver to nip the rising issues surrounding reverse discrimination by recognizing that there were small businesses that could meet the test of being socially and economically disadvantaged but not be minority-owned.⁸ To meet the test of being economically disadvantaged, “the assets and net worth of the applicant [will] be evaluated along with other factors, on the basis of the applicant’s business as compared to others in the same field who are not suffering from social impediments” (Committee on Small Business 1980, p. 22). Thus, the change from a standard of socially or economically disadvantaged to the Public Law 95-507 standard of socially and

economically disadvantaged was an attempt to more narrowly tailor the groups of eligible recipients.⁹

Let us also briefly review what America was going through leading up to Public Law 95-507, socially, legally, and legislatively. The nation was trying to right itself after a tumultuous period of racial discontent in the late 1960s. Affirmative action programs in the United States were used to counteract past discriminatory practices by assuring employment and other resources to specific groups, such as minorities and women. The Civil Rights Act of 1964, as well as Executive Orders 11458 and 11625, provided the enforcement mechanism for government contractors wishing to receive federal funds as a result of these affirmative action programs.¹⁰ With the implementation of such programs, though, came the countercharge of reverse discrimination in the late 1970s, and in *Regents of the University of California v. Bakke* (1978), the U.S. Supreme Court accepted the reverse discrimination argument by saying, "racial and ethnic classifications of any sort are inherently suspect and call for the most exacting judicial scrutiny." After the *Bakke* decision, the U.S. Congress then set out to address the reverse discrimination charges with new legislation.¹¹

Furthermore, Congressman Parren Mitchell of Maryland successfully introduced an amendment to the Local Public Works Act requiring 10 percent of the funds to be set aside for minority contractors. The enactment of this minority business law set in motion a series of legal challenges that used the *Bakke* case of reverse discrimination as their foundation. Thus, as these challenges worked their way through the U.S. courts; and with the recently decided *Bakke* case fresh on the minds of the nation, it became clear that

minority business affirmative action legislation based solely on race and ethnicity with established quotas might not survive legal challenges.

Notwithstanding successful survival of the 10 percent amendment at the federal district and appellate court levels, there were moments of concern that the Supreme Court of the United States would not concur with the actions of these lower courts.¹² On July 2, 1980, the Court ruled that the 10 percent set-aside to the Local Public Works Act was constitutional. The court characterized the program as the “minority business enterprise” (MBE) provision of the Public Works Employment Act of 1977. This act required that, absent an administrative waiver, at least 10 percent of federal funds granted for local public works projects must be used by the state or local grantee to procure services or supplies from businesses owned by minority group members, defined as United States citizens “who are Negroes, Spanish-speaking, Orientals, Indians, Eskimos, and Aleuts.”¹³

The Court concluded that “the minority set-aside program was a legitimate exercise of congressional power.” The Court found that Congress could pursue the objectives of the minority business enterprise program under the Spending Power. The plurality opinion noted that Congress could have regulated the practices of contractors on federally funded projects under the Commerce Clause as well. The Court further held that in the remedial context, Congress did not have to act “in a wholly 'color-blind' fashion.”¹⁴

The need to correct the historical ills of past discrimination while also crafting affirmative action legislation that would provide business assistance without the stigma of being a mandatory quota system was the central theme of Public Law 95-507. Thus, in 1978, Congress acted to explicitly declare, with the enactment of P.L. 95-507, that “[it] is the policy of the United States that small business concerns have the maximum

practicable opportunity to participate in the performance of contracts let by any federal agency, including contracts and subcontracts for subsystems, assemblies, components, and related services for major systems.”¹⁵ Section 211 of the act provides that “no contract shall be awarded to any offeror unless the procurement authority determines that the plan of the proposed prime contractor offers such maximum practicable opportunity.”¹⁶

Public Law 95-507 was heralded by many as the next stage in the immediate economic empowerment of minority businesses because of its focus on providing a statutory framework for the 8(a) program.¹⁷ In fact, House Report 97-956 states that this law is the most comprehensive statute ever enacted dealing with minority business development. The section 211 subcontracting program of Public Law 95-507 was viewed as the long-term solution to business and economic empowerment in the minority communities. It seemed clear that the mainstreaming of American minority businesses would get its biggest boost from working with large businesses. It was believed that bringing these businesses together even under a mandatory requirement of program participation would eventually result in the forging of long-term business relations.¹⁸

While data are not available to show the full impact of this belief, statistics are available that show minority subcontracting increasing from less than one percent prior to Public Law 95-507 to more than 5.4 percent in fiscal year 2003.¹⁹ Also there are case examples of small minority-owned businesses becoming significant subcontractors to large businesses and examples of large businesses receiving national recognition for their support of federal small and socially and economically disadvantaged business programs. Appendix A, as a reference, provides a quick overview of the selected legislative and

regulatory actions that have affected federal prime contractors and subcontractors since 1958.

In summary, Congress set the broad national policy for the maximum utilization of small and small disadvantaged businesses in federal contracting both as prime contractors and as subcontractors. The United States Supreme Court furthered this national policy by providing strong judicial rulings in support of economic affirmative action programs. With these two arms of government having engaged the problem at hand, it became the responsibility of the third leg of government, the Executive Branch, to implement this national small business and minority business policy.

As part of the executive branch, departments and agencies fall under the authority of the president, but they have been empowered to carry out the day-to-day will of Congress. In this regard, the Office of Federal Procurement Policy and the U.S. Small Business Administration are the two primary agencies responsible for day-to-day implementation of Public Law 95-507. Congress created Section 211 of Public Law 95-507 as the nation's policy on small business subcontracting.

Let us now turn to how the executive branch of government implemented the national policy of maximum utilization of small and small disadvantaged business into the federal subcontracting acquisition framework.

COMPONENTS OF THE SECTION 211 SUBCONTRACTING PROGRAM

The Federal Acquisition Regulation, Part 19.7, implemented the requirements of P.L. 95-507 by setting forth the structure for a subcontracting program. The Small Business Subcontracting Program's primary mission is to promote maximum possible use of small

businesses by requiring other than small businesses (OTSBs) that are awarded prime federal contracts to submit a subcontracting plan if the contract 1) exceeds \$500,000 (\$1 million for construction of a public facility) and 2) offers further subcontracting opportunities.

It is the policy of the United States that small business (SB), small disadvantaged business (SDB), women owned small business (WOSB), veteran-owned small business (VOSB), service-disabled veteran-owned small business (SD/VOSB), and Historically Underutilized Business Zone small business (HUBZone SB) concerns have the maximum practicable opportunity to participate in the performance of contracts awarded by any federal agency. OTSB contractors are legally obligated to carry out this policy when awarding subcontracts to the fullest extent consistent with the efficient performance of their contracts.

The Office of Federal Procurement Policy (OFPP) also by Policy Letter No. 80-1, January 24, 1980, further defined the steps to implement section 211 of Public Law 95-507. This policy letter first acknowledged that this law authorized SBA to review any solicitation for any contract over the statutory thresholds. “The purpose of the review is to determine whether maximum practicable opportunity has been afforded small business concerns and small business concerns owned and controlled by socially and economically disadvantaged individuals to participate as subcontractors in such awards.” Policy Letter 80-1 further instructed the procuring activities that the SBA procurement center representative (PCR), shall be provided an opportunity to review any solicitation that meets the statutory thresholds prior to release to the public.

The PCR review encompasses all the required elements of the subcontracting plan, which can be found in Table 2.

TABLE 2
Elements of Small Business Subcontracting Plans

Element	Description
Goals	<ul style="list-style-type: none"> • Goals stated in both dollars (\$) and percentages (percent). The contractor must state the total subcontracting dollars, and then state separately the total dollars that will be subcontracted to SB, SDB, WOSB, HUBZone SB, VOSB and SD/VOSB. The SB dollar amount must include all the small business subset amounts. The percentages must be expressed as percentages of the total subcontracting dollars. Goals for option years must be broken out separately. • Total dollars planned to be subcontracted to each group; • A description of the types of supplies and services to be subcontracted to each group, including the supplies and services to be subcontracted to OTSB subcontractors; • A description of the method used to develop each of the goals; • A description of the method used to identify potential sources; • A statement as to whether or not indirect costs were included in the subcontracting goals.
Plan Administrator	The name of the administrator of the subcontracting plan and a description of his/her duties.
Efforts to Ensure Equitable Opportunities	A description of the efforts the company will make to ensure that SB, SDB, WOSB, VOSB, SD/VOSB, and HUBZone SB concerns will have an equitable opportunity to compete for subcontracts.
Flow-Down Requirements	Assurances that the large business will “flow down” the subcontracting requirements to its subcontractors unless the plan is a commercial subcontracting plan.
Assurances to Cooperate in Studies and Submit Reports	Assurances that the company will cooperate in any studies or surveys as may be required, and submit periodic reports in order to allow the government to determine the extent of compliance by the company with the subcontracting plan. Assurances that its subcontractors agree to submit required reports.
Internal Record-Keeping	A recitation of the types of records the company will maintain to demonstrate its compliance with the subcontracting plan.

Source: U.S. Small Business Administration (1998)

An OTSB prime contractor has several options in developing a small business subcontracting plan. One of these options is to have a plan that covers the entire contract period, including options, applicable to a specific contract. This is known as an individual subcontracting plan. A second option is a master subcontracting plan, which contains all

the required elements of an individual plan, except goals. As the company receives government contracts requiring subcontracting plans, it develops goals specific for each plan. A master plan is in effect for three years; however, when incorporated into an individual plan, it applies to that contract throughout the life of the contract. In comparison, the commercial subcontracting plan, including goals, covers the contractor's fiscal year and relates to the company's production in general, for commercial and noncommercial products or services, rather than solely to the government contract. It applies to either the entire company or a portion of the company (such as a division or product line). This type of plan may be used by an OTSB that is selling a "commercial item" to the government (see definition at FAR 52.202-1). The contractor is not required to submit a Standard Form (SF) 294. The final option is the Department of Defense (DOD) Test Program for Comprehensive Small Business subcontracting plan for selected contractors. This program, limited to a few DOD OTSB contractors, authorizes the negotiation, administration, and reporting of subcontracting plans on a plant, division, or company-wide basis for all defense contracts, rather than individual subcontracting plans for every contract over \$500,000. Additionally, it waives the requirement for the semi-annual SF 294. The purpose of the test is to determine whether comprehensive subcontracting plans will result in increased subcontracting opportunities for small and small disadvantaged businesses while reducing the administrative burdens on contractors (SBA 1998).

After award, OTSB contractors must cooperate in any studies or surveys conducted by the SBA or the awarding agency to determine the extent of the contractor's compliance with this legal requirement. Oversight of the subcontracting plan by the

contracting agency is administered by the awarding agencies' administrative contracting officer (ACO), who is responsible for assisting in the evaluation of subcontracting plans, and for monitoring, evaluating and documenting contracting activities. The ACO's responsibility is separate and distinct from SBA's responsibility.

OTSB contractors provide agencies with information on subcontracting plan status through SF 294 and SF 295 reports, which document the dollars awarded to SB, SDB, HUBZone SB, WOSB, VOSB, and SD/VOSB.

Twice a year, all OTSBs with subcontracting plans must submit an SF 294 report, unless the contractor is operating under an approved commercial subcontracting plan or is currently in the DOD Test Program for Negotiation of Comprehensive Subcontracting Plans. A separate SF 294 report is required for each federal contract and/or subcontract.

The SF 294 report collects subcontract data. This includes the dollar amount and percent of the total planned subcontracting awards and planned SB awards including SDB, WOSB, HUBZone SB, VOSB and SD/VOSB awards. These are the goals that are a material part of the prime contract or subcontract, or, if revised through a contract modification, the revised goals. It also includes the cumulative dollars awarded in each category to reflect the progress made toward the SB, SDB, WOSB, HUBZone SB, VOSB and SD/VOSB goals.

Once a year, the prime contractor must submit a separate SF 295 report to each federal agency stating which subcontractors have performed work for them. For the Department of Defense, contracts are consolidated except for construction and related work (e.g., contracts with the Army Corps of Engineers). A copy of each SF 295 report must be submitted to the commercial market representative (CMR). A CMR is an SBA

employee who is a specialist assigned to the subcontracting assistance program who facilitates the process of matching large business contractors with small, disadvantaged businesses in obtaining subcontracts.

Contractors, OTSBs, and procuring agencies have expressed their concerns over the years for the volume of paper work the subcontracting program has required. In 2005, as part of the President's Management Agenda for Electronic Government, the Small Business Administration (SBA), the Integrated Acquisition Environment (IAE), and a number of agency partners collaborated to develop the next generation of tools to collect subcontracting accomplishments. This government-wide tool is known as the electronic Subcontracting Reporting System (eSRS).²⁰ This Internet-based tool will streamline the process of reporting on subcontracting plans and provide agencies with access to analytical data on subcontracting performance. Specifically, the eSRS eliminates the need for paper submissions and processing of the SF 294s, individual subcontracting reports, and SF 295s, and summary subcontracting reports, and it replaces the paper with an easy-to-use electronic process to collect the data. With the first generation of eSRS, contractors and their business associates will report data through their web browser of choice, visiting this site and logging on to report accomplishments using an easy data entry process.

Subcontracting program compliance reviews deal with all aspects of a firm's small business program. The comprehensive review evaluates the overall effectiveness of a firm's small business program. There are seven mandatory elements of this review, five of which are:

- Validation of the contractor's methodology for preparing reports of subcontracts awarded to all categories of SB and OTSB;
- Five-year trend analysis of the contractor's utilization of all categories of small businesses;
- Overall evaluation of the contractor's small business program;
- Sampling of contracts containing subcontracting goals to determine the actual achievements against the goals for small businesses in all categories;
- Purchase order analysis of awards made to OTSB to identify possible opportunities for small business, to make certain that small businesses are being solicited in every instance possible for purchases over \$100,000 (SBA 1998).

REGULATORY CHANGES TO THE SUBCONTRACTING PROGRAM

In the United States, Congress and the President enact legislation to address a particular issue. Regulatory agencies draft these regulations according to rules and processes defined by the 1946 Administrative Procedure Act (APA).²¹

To increase public awareness of the manner in which regulations were proposed and adopted, Congress passed additional acts (like the Regulatory Flexibility Act, RFA) requiring publication of more detailed information in the *Federal Register*.²²

Regulatory agencies have been given the responsibility and the flexibility to carry out the more precise day-to-day details associated with the broad policy. The APA is the administrative process that guides how these procedures are conveyed to the public and to stakeholders, and the RFA safeguards the interests of small entities. In the mid 1970s, Congress enacted a government-wide policy, requiring the uniformity of acquisition

regulations. In effect, this created the Office of Federal Procurement Policy (OFPP) to provide a government-wide uniform system to manage the acquisition process. The Federal Acquisition Regulation (FAR) System required all federal agencies to play by the same acquisition rule book.

The development of the FAR System is in accordance with the requirements of the Office of Federal Procurement Policy Act of 1974 (Pub. L. 93-400), as amended by Pub. L. 96-83. The FAR is prepared, issued, and maintained, and prescribed jointly by the Secretary of Defense, the Administrator of General Services, and the Administrator, National Aeronautics and Space Administration. Rules implementing these components were required by the APA to be published in the *Federal Register* for a period of time for the purpose of receiving comments from the public and stakeholders.²³

Congress recognized that while it could provide the broad policy framework for requiring federal agencies to maximize the use of small, socially and economically disadvantaged businesses, and while it could empower the OFPP to implement these policies as federal government-wide acquisition regulations, a void existed in the day-to-day management of these small business programs. SBA was given the regulatory responsibility to carry out the day-to-day small business policy directives of Congress. Was this enough to ensure the full implementation of the small business congressional mandate?

In recognition of the need to provide greater oversight of the regulations implementing small business policies, Congress in 1976 established the Office of Advocacy (Advocacy) under Public Law 94-305. One function of the Office of Advocacy is to represent the views of small business before federal agencies and Congress.

Advocacy is an independent office within the SBA, so the views expressed by Advocacy do not necessarily reflect the views of the SBA or of the Administration. The Office of Advocacy is managed by a chief counsel who is appointed by the President of the United States and confirmed by the United States Senate. In 1980, Congress amended Advocacy's duties by adding the Regulatory Flexibility Act. This addition of responsibility came at a time in which the FAR and other federal agencies were beginning to expand the regulatory scope of policymaking. Section 612 of the Regulatory Flexibility Act (RFA) requires Advocacy to monitor agency compliance with the RFA,²⁴ as amended by the Small Business Regulatory Enforcement Fairness Act.²⁵

Advocacy's role in protecting the small business community from ill-advised federal regulations received additional authority and recognition on August 13, 2002. President George W. Bush enhanced Advocacy's RFA mandate when he signed Executive Order 13272, which directs federal agencies to implement further policies protecting small entities when writing new rules and regulations.²⁶ Executive Order 13272 instructs Advocacy to provide comment on draft rules to the agency that has proposed the rule, as well as to the Office of Information and Regulatory Affairs (OIRA) of the Office of Management and Budget.²⁷ Under the executive order, the agency must include, in any explanation or discussion accompanying the final rule's publication in the *Federal Register*, the agency's response to the written comments submitted by Advocacy on the proposed rule, unless the agency certifies that the public interest is not served by doing so.²⁸

As an example of Advocacy's attempt to balance legislative and regulatory policies in the area of subcontract regulations, the Office of Advocacy issued a formal

comment letter to the Small Business Administration on December 18, 2003, regarding several proposed changes to the federal subcontracting program. A part of the text of the letter follows:

The Office of Advocacy commends the Small Business Administration (SBA) for proposing specific responsibilities for large prime contractors to demonstrate good-faith efforts to ensure maximum practicable subcontracting opportunities for small businesses and to fulfill their subcontracting plans. Advocacy urges the SBA to amend proposed section 125.3(b) to exclude small business prime contractors, consistent with the current regulations and authorizing statute underlying the SBA's small business subcontracting assistance program. Small businesses have advised Advocacy that expressly including small business prime contractors under proposed section 125.3(b) will create confusion, will impose new responsibilities and paperwork burdens on small businesses receiving prime contracts, will place additional demands on the shrinking pool of contracting officers, and may have the unintended consequence of penalizing small businesses fortunate enough to receive prime contracts.

The proposed rule amends the regulations that implement the statutorily mandated subcontracting assistance program which is intended to provide maximum practicable subcontracting opportunities for small business concerns.²⁹ The current regulations state that the “purpose of the subcontracting assistance program is to achieve maximum utilization of small business by major prime contractors.”³⁰ This language has been consistent in the Code of Federal Regulations since at least 1998. In its proposed rule, the SBA is proposing changes to section 125.3 that not only clarify the responsibilities of prime contractors to achieve maximum practicable subcontracting opportunities for small businesses, but for the first time impose those responsibilities on small business prime contractors (Office of Advocacy 2003).

As mentioned earlier, the Office of Advocacy works with OIRA and the federal agencies to reduce the regulatory burdens of small businesses. A summary of such activities can be found in Advocacy’s annual reports on RFA compliance. In FY 2005, these interactions resulted in \$6.6 billion in first-year compliance cost savings for small firms, with an additional \$965.6 million in savings each year thereafter (Office of Advocacy 2006).³¹

CONCLUSION

Small business subcontracting is an important tool in the United States to maintain a vibrant and healthy economy. The central role played by small businesses is well-established; this paper and others have focused on the unique role that small firms play in creating net new employment, innovations, and economic growth in the United States and abroad. The American experience shows that small businesses can compete with large businesses with the proper types of governmental support structures. In fact, in some situations, small businesses are better able to compete than their large counterparts.

The U.S. federal government promotes small business procurement opportunities at both the prime and subcontracting levels; and with the enactment of Public Law 95-507, this promotion was extended to include small socially and economically disadvantaged firms as well. Currently, these groups include small businesses; small disadvantaged businesses (including minorities); women-owned small businesses; HUBZone small businesses; veteran-owned small businesses; and service-disabled veteran-owned small businesses. The Federal Acquisition Regulation Council and the U.S. Small Business Administration have implemented the federal goal of increasing small business procurement opportunities to these groups, and this paper has outlined the elements of a small business subcontracting plan. Also discussed here are the roles the Administrative Procedures Act and the Regulatory Flexibility Act play in shaping federal regulations, and thus preserving opportunities for small businesses.

The final task of this paper is to make four recommendations that can enhance the current federal subcontracting program. It is the hope of the authors that these recommendations, in addition to the other parts of this paper, will provide other countries

with a clearer roadmap for their small and medium-sized business subcontracting programs.

RECOMMENDATIONS

The American subcontracting program has the advantage, or sometimes disadvantage, of having been operational for nearly 30 years, with all the lessons garnered from trial and error.

1. While procurement data are available in the United States, it is clear that better data are needed to measure the true effectiveness of achieving procurement goals and policies. Current data cannot measure benefits from procurement. For instance, has discrimination been reduced or eliminated? Are local minority communities benefiting from government contract awards? A concerted effort must be made to produce a more comprehensive data set to allow analysts to more fully examine procurement policy towards small business. Furthermore, new regulatory policy should ideally be introduced alongside data requirements specific to the policy's goals and objectives.
2. The global economy is rapidly creating a need in America for greater flexibility in its small business programs. Public Law 95-507 was enacted in 1978 and has changed very little. Section 211 of this law is not flexible enough to account for new practices in the procurement marketplace. For example, it still assumes that the prime contractor is doing all of the work, whereas the reality is quite different—hence the need for more flexible policies.

3. The traditional contract theory of “privity of contract” has a valid place in contract law to prevent interference in the business relationship between prime contractor and subcontractor. The federal government argues that because it is in contract with the prime and not the subcontractor, it does not have “privity” to enforce a claim by the sub against the prime. While public policies aim to protect small entities, “privity of contract” prevents any intervention by the federal government in resolving disputes, for example, concerning prompt payment or nonpayment, between subcontractors and primes. A more consistent implementation of Congress’ intent and a more focused enforcement of set principles would be ideal in helping small subcontractors bring claims against larger primes. In other settings, mechanisms should be in place for the resolution of such disputes.
4. The federal marketplace is no longer national; it is international. International trade agreements between the United States and other countries have facilitated this transformation. On the one hand, small and small disadvantaged businesses are encouraged to participate in exporting goods and services, but on the other hand, the government continues to impose undue restrictions. This inconsistency harms small entities. For example, FAR Part 19.000(b) does not require prime contractors to submit subcontracting plans for federal contracts where the work is being performed outside of the United States, as previously established. Such policies are a disincentive to small business owners who are ready, willing, and able to compete in the international marketplace. Moreover, these policies may place American small businesses on an un-level playing field with their foreign

competitors. A model international small business subcontracting program should encourage the free flow of business.

APPENDIX A

Selected Legislation and Regulations Affecting Federal Prime Contracts and Subcontracts

Year	Legislation/ Regulation	Description
1958	Public Law 85-536	This legislation amended the Small Business Act of 1953 and authorized a voluntary subcontracting program. Prior to 1978, this statute was implemented most effectively in the Armed Services Procurement Regulations (ASPR), a predecessor to the FAR. It required large contractors receiving contracts over \$500,000 with substantial subcontracting opportunities to establish a program that would enable minority business concerns to be considered fairly as subcontractors or suppliers.
1978	Public Law 95-507	This legislation amended Section 8(d) of the Small Business Act and created the foundation for the Subcontracting Assistance Program. Section 211 of Public Law 95-507 is the same as 8(d), as it is known today. It changed the participation of large contractors in the program from voluntary to mandatory, and it changed the language of the law from “best efforts” to “maximum practicable opportunities.” Key features include: (a) a requirement that all federal contracts in excess of \$100,000 (as amended) provide maximum practicable opportunity for small and small disadvantaged businesses to participate; and (b) a requirement that all federal contracts in excess of \$500,000 (\$1,000,000 in the case of construction contracts for public facilities) is accompanied by a formal subcontracting plan containing separate goals for small business and small disadvantaged business.
1984	Public Law 98-577	The Small Business and Federal Procurement Act of 1984. This legislation amended the Small Business Act as follows: (a) by providing that small and small disadvantaged businesses be given the maximum practicable opportunity to participate in contracts and subcontracts for subsystems, assemblies, components, and related services for major systems; and (b) by requiring federal agencies to establish procedures to ensure the timely payment of amounts due pursuant to the terms of their subcontracts with small and small disadvantaged businesses.
1987	Public Law 99-661	The National Defense Authorization Act of 1987. Section 1207 of this statute required the Department of Defense to establish as its objective a goal of five percent of the total combined amount obligated for contracts and subcontracts entered into with small and small disadvantaged businesses in each of fiscal years 1987, 1988, and 1989. Also, the use of SDB set-asides was authorized. (Subsequent legislation extended this period through the year 2000; however, the set-aside aspect of the program was suspended in fiscal year 1996.)
1988	Public Law 100-180	Section 806 required the secretary of defense to increase awards to small and small disadvantaged businesses.
1988	Public Law 100-656	The principal focus of this legislation was the 8(a) Program, but it contained a number of other provisions which affected the Subcontracting Assistance Program. These other provisions included the following: (a) Section 304 requires that the FAR be amended to include a requirement for a contract clause authorizing the government to assess liquidated damages against large contractors which fail to perform according to the terms of their subcontracting plans and cannot demonstrate that they have made a good faith effort to do so; (b) Section 502, now codified at 15 U.S.C. Section 644(g)(1), requires the president to establish annual goals for procurement contracts of not less than 20 percent for small business prime contract awards and not less than 5 percent for small disadvantaged business prime contract <u>and subcontract awards</u> for each fiscal year [emphasis added]; and, (c) Section 503 requires the SBA to compile

Year	Legislation/ Regulation	Description
		and analyze reports each year submitted by individual agencies to assess their success in attaining government-wide goals for small and small disadvantaged businesses, and to submit the report to the president.
1990	Public Law 101-189	Defense Authorization Act. Section 834 established the Test Program for the Negotiation of Comprehensive Subcontracting Plans. This statute authorized a pilot program limited to a few Department of Defense large contractors approved by the Office of Small and Disadvantaged Business Utilization (OSDBU) at the Pentagon. The program allows these companies to have one company-wide subcontracting plan for all defense contracts, rather than individual subcontracting plans for every contract over \$500,000, and it waives the requirement for the semi-annual SF 294 <i>Subcontracting Report for Individual Contracts</i> . The large contractor is still required to submit the SF 295 semi-annually, and it is required to have individual subcontracting plans and to submit SF 294s on any contracts with other government agencies. Public Law 103-355, Section 7103, extended this test program through September 30, 1998.
1990/1	Public Law 101-510	The National Defense Authorization Act for Fiscal Year 1991. Section 831 established the Pilot Mentor Protégé Program to encourage assistance to small disadvantaged businesses through special incentives to companies approved as mentors. The government reimburses the mentor for the cost of assistance to its protégés, or, as an alternative, allows the mentor credit (a multiple of the dollars in assistance) toward subcontracting goals. Prior to receiving reimbursement or credit, mentors must submit formal applications.
1992	Public Law 102-366	The Small Business Credit and Business Opportunity Enhancement Act. Section 232(a) (6) removes the requirement from SBA to do the Annual Report to Congress on Unacceptable Subcontracting Plans, which had been found in Section 8(d) of the Small Business Act.
1994	Public Law 103-355	The Federal Acquisition Streamlining Act. FASA significantly simplifies and streamlines the federal procurement process. Section 7106 of FASA revised Sections 8 and 15 of the Small Business Act to establish a government-wide goal of 5 percent participation by women-owned small businesses, in both prime and subcontracts. Women-owned small businesses are to be given equal standing with small and small disadvantaged business in subcontracting plans. In practical terms, this means that all subcontracting plans after October 1, 1995, must contain goals for women-owned small businesses and that all FAR references to small and small disadvantaged business have been changed to small, small disadvantaged, and women-owned small business.
1997	Public Law 105-135	The HUBZone Empowerment Contracting Program, which is included in the Small Business Reauthorization Act of 1997, stimulates economic development and creates jobs in urban and rural communities by providing contracting preferences to small businesses that are located in HUBZones and hire employees who live in HUBZones.
1999	Public Law 106-50	The Veterans Entrepreneurship and Small Business Development Act. This established a goal for subcontracts awarded by prime contractors to service-disabled veteran-owned small business concerns of 3 percent. A best effort goal will be established for veteran-owned small businesses. Subcontracting plans must incorporate these goals.
	FAR Part 19 (48 CFR)	Implements the procurement sections of the Small Business Act. Federal contracting agencies must conduct their acquisitions in compliance with these regulations. OTSB contractors are required to comply with certain clauses and provisions referenced in the FAR. These are: (a) Subpart 19.1 prescribes policies and procedures for size standards (also in Title 13 of the U.S. Code of Federal

Year	Legislation/ Regulation	Description
		Regulations); (b) Subpart 19.7 prescribes policies and procedures for subcontracting with SB, SDB, WOSB, VOSB, SD/VOSB, and HUBZone SB concerns; (c) Subpart 19.12 prescribes policies and procedures for the SDB participation program including incentive subcontracting with SDB concerns; (d) Subpart 19.13 prescribes policies and procedures for the HUBZone SB program.

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ENDNOTES

¹ The views expressed in this article are those of the authors and do not necessarily reflect the views of the Office of Advocacy, the SBA, or the U.S. Government.

² Public Law 83-163 § 202.

³ The Office of Advocacy has produced tables based on Statistics of U.S. Business (SUSB) static and dynamic data from the U.S. Census Bureau. This firm-size data, the basis for the job generation claim, can be found at:

<http://www.sba.gov/advo/research/data.html>. In particular, please note the link titled “U.S. births, deaths, and job creation, 1989-2002;” see

http://www.sba.gov/advo/research/dyn_b_d8902.pdf. One can see that the net new jobs figure for small businesses has hovered between 60 and 80 percent for most years.

⁴ For more information, see <http://www.actetsme.org/japa/smepolicies>.

⁵ 15 U.S.C. § 637(d). See also 15 U.S.C. § 644(a) (providing that it is in the interest of the government to ensure that “a fair proportion of the total purchases and contracts for property and services for the Government in each industry category are placed with small business concerns.”)

⁶ *Id.*

⁷ Public Law 95-507, House Report 95-949, March 13, 1978.

⁸ In fact, according to the Conference report for Public Law 95-507, “the Conferees realize that other Americans may also suffer from social disadvantage because of cultural bias. For example, a poor Appalachian white person who has never had the opportunity for a quality education or the ability to expand his or her cultural horizons, may similarly be found socially disadvantaged, providing that the conditions leading to such disadvantage are beyond the ability of the person to control.” (Committee on Small Business 1980, p. 22).

⁹ Personal interview with Thomas Trimboli on April 4, 2006.

¹⁰ Civil Rights Act of 1964 and Executive Orders 11458 and 11625.

¹¹ 438 U.S. 265. *University of California Regents v. Bakke*. 1978.

¹² One of the authors, having a personal opportunity to attend the oral arguments before the U.S. Supreme Court in the *Fullilove* case, can attest to the uncertainty of the courts ruling based on the types of questions of the justices.

¹³ 448 U.S. 448 *Fullilove v. Klutznick*, No. 78-1007, July 2, 1980.

¹⁴ *Id.*

¹⁵ 15 U.S.C. § 637(d). See also 15 U.S.C. § 644(a) (providing that it is in the interest of the government to ensure that “a fair proportion of the total purchases and contracts for property and services for the Government in each industry category are placed with small-business concerns”).

¹⁶ *Id.*

¹⁷ Testimony of Vernon Weaver, SBA Administrator, to the U.S. House Small Business Committee. April 10, 1979.

¹⁸ Testimony of Terry Ford, Assistant to the President of Gould’s Ocean Systems Division, U.S. House Small Business Committee. June 18, 1981.

¹⁹ See Table 1 and Committee on Small Business (1980). The latter report states on page 52 that small, minority-owned businesses received 0.9 percent of military subcontracts in FY 1976. Large businesses received 62.5 percent of all military subcontracts.

²⁰ For more information on the Electronic Subcontracting Reporting System, see <http://www.esrs.gov/>.

²¹ Administrative Procedures Act 5 U.S.C. sections 551-59.

²² The Regulatory Flexibility Act, Pub. L. No. 96-354, 94 Stat. 1164 (codified at 5 U.S.C. § 601 *et seq.*).

²³ 48 CFR Chapter 1.

²⁴ For more information on the Regulatory Flexibility Act, see Holman (Forthcoming).

²⁵ Pub. L. No. 96-354, 94 Stat. 1164 (1981) (codified at 5 U.S.C. 601-612) amended by Subtitle II of the Contract with America Advancement Act, Pub. L. No. 104-121, 110 Stat. 857 (1996). 5 U.S.C. 612(a).

²⁶ Exec. Order No. 13272 1, 67 Fed. Reg. 53461 (Aug. 16, 2002).

²⁷ E.O. 13272, at 2(c).

²⁸ *Id.* at 3(c).

²⁹ Small business concerns also include small business concerns owned and controlled by veterans, small business concerns owned and controlled by service-disabled veterans, qualified HUBZone small business concerns, small business concerns owned and controlled by socially and economically disadvantaged individuals and small business concerns owned and controlled by women.

³⁰ 13 CFR 125.3(a).

³¹ In FY 2005, the Office of Advocacy had \$6.6 billion in regulatory compliance “cost savings.” These “cost savings” refer to compliance costs that a small business would have had to incur if a regulation had been finalized as originally drafted. Due to the RFA and the efforts of the Office of Advocacy, OIRA, the federal agencies, and other parties, these “cost savings” are possible. Note that annual reports on RFA compliance are available online and can be found at: <http://www.sba.gov/advo/laws/flex/>.