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TECHNICAL
REPORT

Enhancing Small-Business Opportunities in the DoD

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Prepared for the Office of the Secretary of Defense

Approved for public release; distribution unlimited

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The research described in this report was prepared for the Office of the Secretary of Defense (OSD). The research was conducted in the RAND National Defense Research Institute, a federally funded research and development center sponsored by the OSD, the Joint Staff, the Unified Combatant Commands, the Department of the Navy, the Marine Corps, the defense agencies, and the defense Intelligence Community under Contract W74V8H-06-C-0002.

Library of Congress Cataloging-in-Publication Data is available for this publication.

ISBN 978-0-8330-4580-5

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Published 2008 by the RAND Corporation
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Summary

For several decades the federal government has sought to aid and assist small businesses. These efforts have included congressional establishment of government-wide statutory goals for the federal government to purchase at least 23 percent of all its goods and services from small businesses.

Because the Department of Defense (DoD) purchases about two-thirds of all goods and services the federal government buys, its purchasing practices greatly affect the success of federal procurement policy favoring small businesses. The DoD has had mixed success in meeting the procurement goal. Given the importance of DoD purchases to government-wide small-business procurement efforts, Congress asked the DoD Office of Small Business Programs for an assessment of impediments to small-business owners in contracting or subcontracting with the department. This report fulfills that request. Among issues we consider are the unique needs of the DoD and how they affect opportunities with small businesses, contract "bundling," subcontracting in professional services and research and development, opportunities in the Small Business Innovation Research (SBIR) and the Mentor-Protégé Programs, electronic payment systems, and whether firms "graduate" from the programs or increase in size from "small" to larger businesses as a result of various small-business preferences, including those for procurement.

Opportunities by Industry

The DoD purchases goods and services in an enormous variety of industries. In addition to traditional defense goods such as armored vehicles and ammunition, the DoD purchases at least $500 million in prime contracts annually from grocery, apparel, pharmaceutical, and construction industries.

Still, more than half of DoD purchases are concentrated in just ten industries. In many of these industries, the small-business share of sales to the DoD is below the small-business share of all industry sales. In some industries, including aircraft manufacturing and engineering services, the two industries in which the DoD spends more money than any other, this is because small businesses are less prevalent than they are elsewhere in the economy. In aircraft manufacturing, for example, small firms account for less than 10 percent of the industry, in contrast to their 51 percent share of the overall gross domestic product. It is also possible that small firms within aircraft manufacturing are less likely to make the type of larger transport or advanced fighter aircraft the DoD needs. In other industries, DoD purchases could perhaps include more small businesses, but further research would be needed before identifying specific

opportunities with small businesses within them. In still other industries, particularly those from which the DoD makes fewer purchases, the DoD already exceeds the share that small businesses have of industry sales.

Evolving DoD needs may further constrict the opportunities available to small business. Among its broad categories, DoD purchases from small businesses have traditionally been greatest in military construction and family housing and less prevalent in weapon system procurement. As a result, in future years, should weapon system procurement increase relative to other spending, as it is currently projected to do, the small-business share of overall DoD purchases is likely to diminish.

Bundling

Federal procurement regulations seek to limit consolidation of contracts into a single contract that is not suitable for award to a small business. Indeed, such bundling has been identified by the President and Congressional leaders as a leading impediment to small-business participation in federal contracting opportunities. The prevalence of such practices in DoD and other federal contracting is difficult to determine. One estimate of bundling contends that more than half of DoD prime contract spending is on bundled contracts. Yet another, noting the few formal protests filed over bundling, maintains that there are far fewer cases of bundling. The DoD's own data on bundling are lacking. Given that consolidation of multiple contracts is likely to remain among the purchasing practices that the DoD seeks to adopt, more accurate data are needed on the contract bundling practices that the government seeks to limit as well as on contract consolidations it can accept.

Subcontracting

In addition to statutory goals for prime contracting with small businesses, the Federal Acquisition Regulation requires that other-than-small businesses submit a subcontracting plan for each solicitation or contract modification that exceeds $550,000 (or $1 million for construction) and offers subcontracting opportunities. Of particular interest to Congress are subcontracting opportunities in research and development (R&D) as well as in professional services. DoD spending in real terms during the past decade more than doubled in R&D and more than tripled in professional services. The small-business share of DoD prime contract dollars for R&D, especially outside that for defense systems, has decreased in recent years, whereas the proportion of dollars spent on contracts requiring a subcontracting plan has increased. Within professional services, the percentage of DoD contract dollars requiring a subcontracting plan has also increased. As a result, small-business subcontracting opportunities in both areas may be increasing, and small-business opportunities in R&D may be shifting from prime contracts to subcontracts. Unfortunately, direct data on DoD subcontracting in these industries are unavailable for analysis. Currently, there is no centralized database for collecting DoD subcontracting data. Nevertheless, the DoD is deploying the Electronic Subcontracting Reporting System which will have data available for analysis.

SBIR Program

The DoD uses the SBIR program to involve small businesses in its R&D programs. The program is funded by a 2.5 percent assessment placed on external research budgets. It now provides more than $1 billion annually in funds to be spent with small businesses to develop technological innovations. Congress is particularly concerned with how well SBIR technologies move into acquisition programs. Common impediments to such transition in the DoD and other federal agencies are insufficient technical maturity of projects when SBIR funding ends, lack of funding for further development of immature technology, and, as previous RAND research found, program managers who view the program as a burden rather than as a development opportunity.

Mentor-Protégé Program

An additional means used to increase small-business participation in federal contract opportunities is the Mentor-Protégé Program in which large prime contractors, or mentors, assist certain categories of small businesses, or protégés, to improve their capabilities (including in organizational structure and technology transfer) as suppliers for federal agencies. Data on the program have been limited, although it appears to be popular among both mentors and protégés and perhaps has helped boost the size of protégé firms. Mentor incentives for the program include reimbursement for program participation or credit toward subcontracting goals; the reimbursement option is preferred and hence may be critical to continued operation of the program. DoD protégés report increased revenues from program participation, with exposure to other federal contracting opportunities also viewed positively. Nevertheless, further research is needed on whether the program contributes directly to its goal of boosting small-business opportunities.

Electronic Payment Systems

Congress has expressed specific concern about requirements to use Vendor Pay for small businesses and how this may affect small-business participation in DoD contracts. Surveys regarding technology in small businesses likewise suggest that electronic pay systems could be a problem. Yet the effect of DoD's e-commerce systems on small businesses appears to be minimal, and small businesses are offered sufficient support to become acquainted with the system. In fact, DoD's e-commerce systems appear to be an improvement over its manual payment methods, given that small businesses have expressed a preference for electronic payment because of the ease in submitting invoices and receiving payments.

Small-Business "Graduation"

Among the aims of small-business policy are preserving free competitive enterprise and strengthening the overall economy of the nation. Ideally, small firms helped by federal policies that support these aims will, over time, become larger firms. Identifying the extent of such

"graduation" with current data is challenging. Nevertheless, our analysis of small businesses in Central Contractor Registration (CCR) data indicates that relatively few small firms providing goods and services to the DoD have graduated over time. Of contractor identification codes appearing in the data between 1997 and 2007 with contract actions reported as going to small businesses, 44 percent were inactive in 2008, suggesting that such firms were either out of business, were acquired by another firm, or were no longer seeking federal contracts; 43 percent were for businesses that had remained "small"; 4 percent were for contractors that dealt in multiple industries, being small in some but not others; and 9 percent were for contractors that were no longer small. Annual archiving of CCR data to better track revenue, growth, and mergers for businesses over time would help foster a better understanding of small-business growth, graduation, and acquisition. Future research might also focus on how larger or longer contracts can help small businesses grow and "graduate" from procurement preferences.

Recommendations

This research points to several steps federal policymakers could take to address impediments to small-business participation. Reconsideration by the Small Business Administration of what truly defines a small business may result in inclusion of firms not currently receiving small-business preferences but able to bring to market some of the innovations sought through such policies. This might include recognition of the large scale of production or investment necessary in some industries. In extreme cases, this might even include recognizing as "small" all firms not dominant in an industry. Setting goals by industry rather than across the government similarly could help the DoD foster small-business opportunities in industries most conducive to them. Implementing any remedies would require careful analysis of affected industries, including how trends such as globalization or electronic commerce are affecting market dynamics.

Other initiatives will require more sophisticated data analysis to help determine both how well small-business policies are currently performing in meeting their objectives as well as what these objectives should be. Data on contract bundling and subcontracting are lacking or deeply flawed. There have been no efforts to assess how programs such as Mentor-Protégé have directly contributed to their broader objectives. Without more adequate data, Congress may find it difficult to devise solutions to the impediments we discuss, and DoD managers will have difficulty in implementing any solutions.