Using a tiered size standard based on the number of employees only

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Solutions Proposal

Introduction

During a recent 12-week series of nine summit meetings, Set-Aside Alert publication and the National Federal Contractors Association (NaFCA) worked with federal small business contractors to develop several comprehensive proposals for reforming the Small Business Administration's (SBA) size standards policies. Those meetings were elicited by an acute understanding, particularly in view of our nation's current economic condition, that there is an urgent need to bring fairness and efficency into size standard determinations for small businesses. Without such reform, the SBA will not be able to maintain and strengthen the nation's economy by enabling the establishment and continued competitive viability of small businesses.

The working group addressing size standards management recommends using a tiered approach, similar to the one successfully used in the Department of Commerce's COMMITS and the Department of Homeland Security's EAGLE programs. The working group recommends that this tiered approach should be expanded in order to assure that the smallest of the small firms, including start-ups and developing firms, are protected during their new business development period while providing them with the unrestricted ability to bid up to the highest tiers.

The working group concluded that a tier concept will also provide government managers the ability to increase their support to small business federal contractors, enabling them to procure 'niche' capabilities while maintaining support of the government's broad statements of work, often used to cover a wide range of needs not identified at the beginning of the contract period. In today's market place, most statements of work cover a wide range of work to be performed.

Problem

Congress realized the significance of small businesses to the economic vitality of the U.S. when it authorized the SBA to aid, counsel, assist and protect the interests of small business concerns. Since that time, technology, social trends, demographics, inflation, escalating operating costs, heightened liability risks, and competitive employee compensation have impacted companies' competitive viability. Therefore, the current SBA methodology for size standard determinations is obsolete; it impairs the Agency's ability to meet its charter and results in reckless waste of significant taxpayer funds without promoting the success of meaningful small business programs that stimulate the economy and mitigate inflation. As a matter of fact, the SBA's mission statement declares that the policies of the Agency should assist small businesses by encouraging and strengthening their competitive viability within the U.S. economy. Yet we find that the

Agency is currently working against its own purpose, due to its insistence on using antiquated size standards and methodologies that fail to support small businesses that are not dominant in their field of operation.

The consequence of current size standard policies is evident. After cumulatively promoting economically vital domestic employment, numerous small businesses doing business with the federal government are forced to halt their positive growth to avoid exceeding an unrealistic and artificially derived revenue-based industry cap, that in many cases translates to a staff of less than 100 individuals. Further, non-dominant businesses outgrow their respective unrealistic and artificial small business size standard with as few as 150-500 employees and in doing so, are suddenly forced to compete with firms many times their size in order to pursue business opportunities. As a result of these developments, once it becomes obvious that graduated small businesses are unable to compete with much larger companies, they are forced to sell their assets, and reduce their resources, operations and quality in order to survive. In the end, the publicly funded investment that built small companies, their specific capabilities and innovation, find themselves in the cycle of assisting only micro start-ups that are not matured in a manner that allows them to responsibly compete with mega-companies, or world market influences.

The government needs to create an environment for all businesses to thrive, increasing competition and assuring greatest value for taxpayer dollars. This should encompass businesses of all sizes. Yet, according to a November 2010 report by the Center for Strategic and International Studies (CSIS), mid-tier companies, a conduit for new ideas and improved business practices, are squeezed out of the marketplace:

> "[I]t is clear that those in the middle tier have suffered an erosion of their relative share. In 1995, middle-tier companies captured 40 percent of the total value of federal professional services contracts. By 2009, the middle-tier companies were able to capture only 30 percent of that value. At the same time, (…) [s]mall companies have sustained a 19–22 percent market share in the value of prime contracts. The large companies in this industry have been particularly active via mergers and acquisitions and have been able to increase their market share from 41 percent of the total market in 1995 to 48 percent in 2009. Thus, the middle tier has been squeezed from above by consolidation and from below by the slight growth in small contractors' share of the market"

It follows that the critical value of small and mid-tier businesses to the industrial base can be retained only with a change to size standards from the existing three-year average annual revenue to number of employees.

We acknowledge that some small business entrepreneurs purposely want to maintain a small business size and are well within their rights to do so. These often family-owned businesses aim to provide employment for themselves and their families above all. Such businesses are comparable to the millions of small businesses in the commercial sector with less than 50 employees and are often the very focus of SBA policy-making. By contrast, once firms reach as many as 300 employees they are frequently perceived as big business, even though they may still be considered small under a number of NAICS codes. It is not common sense to equate the competitive viability of second-tier small businesses with that of industry giants like Lockheed Martin, Northrop Grumman and Raytheon. In comparison with those firms, businesses with revenues exceeding $25 million dollars are effectively still small.

The proposed size standard regulations that SBA released raises the IT size standards from $25M to $25.5M. We seem to understand the methodology that SBA used to arrive at the proposed changes. There are many real-life examples, however, showing how disconnected SBA policymakers are to market realities. It is clear that when first conceiving of size standards, policymakers have given no consideration to the way the federal market would evolve over the years. It is hardly justifiable to increase the size standards by $500,000, claiming a $25.5M business would now be more competitively viable. Even in those NAICS codes where the proposed regulations double the size standards for revenues, the affected small businesses will not be able to increase capacity and capability enough over the long run to be competitively viable in the full and open competition in the federal marketplace.

Recommendations for Correcting Restrictive Size-Standards

The working group believes that the backbone of the U.S. economy resides with non-dominant businesses that are postured to better compete within world markets. The current North American Industry Classification system (NAICS) code/size standards policies do not adequately support SBA's mission to promote and foster competitive viability for businesses not dominant in their field of operation.

First, we recommend elimination of the current revenue standards for small business determination in favor of an employee-count only size standard as is already applied, for instance, to Engineering, Logistics, SETA and Telecommunications, where a business is still considered small if it employs fewer than 1,500 people, regardless of its three-year average sales. In those industries where a size-standard has not been identified, we recommend using a size-standard of 1,500 employees. Several economists have concluded that average revenue is an *inappropriate measurement of business size*.

Second, we recommend developing different size standards for businesses operating in the public and private sectors. In particular, the government imposes a number of restrictions upon the business practices and operations of federal contracting businesses that have no equal in the commercial sector. Additionally, there are many more firms with fewer than 50 employees in the commercial sector compared to the federal marketplace, where small firms still have to be large enough to successfully compete for contracts in full and open competition against $30B giants.

The biggest reform required from present policymakers is to accept that there is an immense difference between doing business in the commercial and federal market sectors. For that reason it is of the highest significance that SBA implements a different business strategy for the commercial versus the federal market sector. Today, because there has been no major change for four decades and judging from the public response to the 2011 proposed regulations, the community seems to be conditioned to think that SBA policymakers are above all bureaucrats who lack common sense about real-life business practices in the federal government. The SBA approach to small business federal contracting as it relates to size standards policy are using yesterday’s tools to address today’s problems: it is as though they insist on using Polaroid’s when digital cameras are available, or telegraph where they could use email/internet, or a payphone where they could use cell phones.

Third, we recommend a five-year *pilot program* be designed and employed in which Contracting Officers may elect to use the number of employees to determine small business status. This pilot should aim to provide a level playing field by building upon concepts already in place, such as the aforementioned Engineering, Logistics, SETA and Telecommunications size standard, which designates small businesses by the number of employees ranging from 500-1,500. In the pilot program, it would be helpful to establish tiers based on the number of employees to determine various sizes of small businesses. The following tiered size-standard system should serve to more adequately define small businesses in the U.S. economy and allow competition among peers:

Number of Employees	**Tier**
1-50	Tier 1
51-150	Tier 2
151-300	Tier 3
301-500	Tier 4
501-1,000	Tier 5
1,001-2000	Tier 6

The pilot program should be designed to ensure businesses performing under current socio-economic programs are not disadvantaged by the tier system. To ensure that goal, all lower tier small businesses may "bid up" but higher tier businesses may not "bid down" for lower tier set-asides. Using a pilot program also provides the flexibility to make interim adjustments.

An alternative approach to using a tiered strategy would be to tie the tier to contract value, in order to enable contracting officers to more easily select which tier to assign a given contract to. The following is one model which may be used, though contract values are subject to adjustment:

Number of Employees	**Tier**	**Contract Value**
1-50	Tier 1	\$0 - 5M
51-150	Tier 2	\$6 – 50M
151-300	Tier 3	\$51 – 150M
301-500	Tier 4	\$151 – 300M
501-1,000	Tier 5	\$301 – 500M
1,001-2000	Tier 6	\$500M+

Background

Under the current system, the definition of small business in a majority of industries hinges on an entity's three-year average receipts. Most small businesses provide services in which the NAICS ceiling is set either at \$7 million or \$25 million (see Appendix, Table 1). The highest annual receipts-based size standard for small business in any service industry is \$35.5 million.

This system fails to effectively address economies of scale when small businesses are forced to compete against significantly larger businesses such as Northrop Grumman, Lockheed Martin, SAIC, EDS-Hewlett Packard, and General Dynamics. These mega-corporations average sales of $30 billion per year and have 130,000 employees. Once the dollar threshold of the NAICS definition for small business is surpassed, every business, even one with only $8 million per year in sales, is thrust into the unrestricted fully competitive market without the infrastructure and capital needed to compete successfully against significantly larger businesses, such as the top six federal government systems integrators named above. How can an $8 million be expected to compete against a $30 billion giant on a consistent basis?

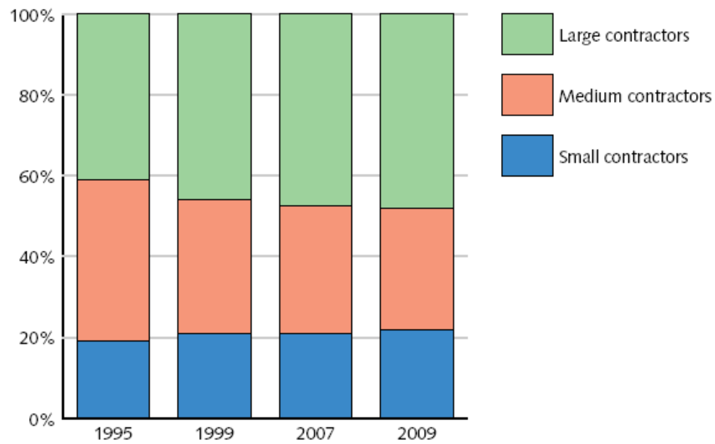
The purpose of small business set-asides is to provide a level playing field for competitors of similar size. However, the present size standards design cannot be interpreted as being reasonable in promoting competitive viability for developing firms or aiding their ability to gain competitive capacity. Due to the lack of any realistic modification to size standard thresholds over the years, small businesses' ability to sustain themselves after exceeding their size standard thresholds is questionable. They are forced to travel a bumpy road just to survive. Consequently many have been sold or closed their doors.

For many years, second-tier companies in the federal services sector have been highly regarded as a source of innovation and productivity. They have the ability to perform and manage complex contracts with low risk. Because of their success in establishing themselves beyond the first-tier small business threshold, they have proven infrastructures and management processes, capabilities invaluable to the government and to our economy as a whole.

Changing the revenue size standards to employee head count more properly reflects the reality of today's marketplace. Having never been defined formally, there is much discussion about what constitutes the size of a mid-tier company. Regarding the professional services industrial base, Gregory Sanders et al.'s report *Structure and Dynamics of the U.S. Federal Professional Services Industrial Base 1995-2009* states, "The most notable change from prior years is that the cutoff for being a large contractor is now $3 billion……". Further research indicates that the lowest revenue figure for the mid-tier range is $1 billion annually. All businesses beneath that should clearly be considered small.

But in recent decades, those second/mid-tier firms, by virtue of being neither small enough nor large enough to successfully compete, have seen their share of the market decline considerably, according to Sanders report.

Figure 3-14. Market Share of Small, Medium, and Large Contractors in the Federal Professional Services Industry, 1995, 1999, 2007, and 2009



Source: Federal Procurement Data System; analysis by CSIS Defense-Industrial Initiatives Group.

The Executive Summary of the report summarizes some of the authors' findings about market shares of mature/mid-tier/second-tier federal contractors compared to those of their small (as designated by the SBA) and large counterparts (with annual revenues exceeding $3 billion). Below are reprinted some of the report's significant findings.

> "The scale, range, and magnitude of critical mass has changed. In 1995, contract awards near a half billion dollars allowed an organization to be contractor number 20 in the top 20; in 2009 that ranking required annual awards of $1.9 billion."
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> "Across the federal government, large contractors win the greatest percentage of agencies' contract award dollars."
>
> "[I]t is clear that those in the middle tier have suffered an erosion of their relative share. (…) Thus, the middle tier has been squeezed from above by consolidation and from below by the slight growth in small contractors' share of the market."
>
> "Policymakers must determine whether a robust middle tier of services companies is important or desirable for the federal marketplace. If so, current incentives for companies to enter and remain in this mid-market level must be revisited."

Indeed, mature/second-tier small businesses lose all of the contracting incentives provided under the Small Business Programs. The impact this has on the marketplace, was illustrated by the House Armed Services Committee report on acquisition reform in March 2010, which states:

> "The length and scope of weapon system programs has accelerated defense industry's consolidation around a handful (…). Only the largest firms have access to the resources and expertise to bid on the most complex programs and it is difficult for firms of all but the largest size to survive losing them. As a result, competition is reduced at the front end of programs, and all but eliminated in the sustainment phase….Small businesses are largely locked out of the process or accorded contracts only on the goodwill of one of the larger firms."
>
> Consequently, "mid-tier companies are either absorbed or decide to abandon defense acquisition for [the] more competitive commercial sphere (…). Winning or losing

> individual contracts becomes such a critical matter that the incentives to protest contract awards are overwhelming. (…) The end result of this process is the gradual erosion of competition and innovation in the defense industrial base."

Many are beginning to realize that something needs to change for mature/second-tier small businesses to remain competitively viable. For instance, in 2010, the Quadrennial Defense Review states

> "Whenever possible and appropriate, the Department will rely on market forces to create, shape, and sustain industrial and technological capabilities, but we must be prepared to intervene when absolutely necessary to create and/or sustain competition, innovation, and essential industrial capabilities."

Elsewhere, the report states "the vast majority of innovative and revolutionary components, systems, and approaches that enable and sustain our technological advantage reside in the commercial marketplace, in small defense companies, or in America's universities. Therefore, the Department will work to (…) take full advantage of the entire spectrum of the industrial base at our disposal (…) [including] the increasingly important sector of those innovative and technologically advanced firms and institutions that fall somewhere in between. (…) [This] mean[s] that the Department will create an environment in which our industries, a foundation of our nations' strength, can thrive and compete in the global marketplace."

Conclusion

The numerous size standards based on three-year average annual revenue/receipts is no longer consistent with marketplace dynamics. All annual revenue dollars are the basis for calculation of the three-year average. Often, computer size standards, hardware and subcontracting are part of the contract award dollars. The success of a graduated small business is dependent on building an infrastructure to compete with companies that have billions of dollars in annual revenue.

Federal agencies' procurement practices such as bundling favor big companies and create structural impediments to small business tier growth and even survival. In this environment, large primes all too frequently wipe out or acquire second-tier contractors to the point where only a handful of companies dominate the market. Very often small businesses are forced to sell out or close once they exceed their small business NAICS ceiling because they cannot succeed in competition with huge oligopolies.

Against that backdrop, it is our belief that small businesses need the assistance of the SBA until they exceed at least 1,500 employees. This is because business growth is an evolutionary process and competition from companies with many thousands of employees will always have the power to out-scale, overcome and eradicate very small competitors if given the chance to do so.