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# QUESTIONING THE SACRED COW: REEXAMINING THE JUSTIFICATIONS FOR SMALL BUSINESS SET ASIDES

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## I. INTRODUCTION

In 1955, Professor Arthur Miller called the small business “[o]ne of the most sacred of the current sacred cows on the national political scene.”<sup>1</sup> Over fifty years later, the small business set aside has become “one of the most sacred of the current sacred cows” of the federal procurement scene.

The use of small business set asides has generated consequences that run counter to some of the fundamental principles of government contracting, most notably the principles that full and open competition should be the norm, that procurement awards should be based on “best value” considering price and quality, and that all contractors should be given equal opportunity to compete.<sup>2</sup>

Despite these contradictions, set asides have survived due largely to their widespread appeal. Politicians support set asides to demonstrate their commitment to small business interests. Small business owners support set asides because they eliminate competition in the marketplace and, at least theoretically,

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1. Arthur Miller, *Government Contracts and Social Control: A Preliminary Inquiry*, 41 VA. L. REV. 27, 43 (1955).

2. See FAR 1.102.

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allow small businesses to acquire contracts they might not otherwise win through full and open competition.

Although set asides based on racial preferences have been the subject of much debate, there seems never to have been a serious debate about set asides based on business size.<sup>3</sup>

Supporters of small business set asides assert several justifications, which for simplicity can be grouped into three categories: (1) values justifications, (2) economic justifications, and (3) competitive justifications.<sup>4</sup> When examined closely, these justifications appear shallow and unsatisfying, especially when contrasted with the potential costs of small business set asides. Consequently, these justifications often raise more questions about the prudence of set asides than they answer. To take seriously the notion that procurement dollars should be spent in an economically responsible manner, a renewed debate about the prudence of such policies must take place.

Unfortunately, balancing the benefits of small business set asides with their costs is virtually impossible, as the information necessary to draw an ultimate conclusion is fundamentally flawed, limited, or nonexistent. Seeking to raise questions which have previously been ignored, this note hopes to become a catalyst for further research, discussion, and debate about the merits of these often-ignored policies.

Part II of this note details the history of small business set asides. It focuses on how the justification and interpretation of the "fair proportion" language of the Small Business Acts have evolved from a policy designed to advantage the Government to an entitlement designed to advantage small businesses. Part III discusses the costs of small business set asides to the procurement system and the American taxpayer. Part IV reexamines and questions the values, economic, and competitive justifications for small business set asides. Finally, this note argues that given the inevitable costs of such policies on the procurement system and the American taxpayer, more study is needed to begin a serious debate about this difficult issue.

## II. HISTORY OF SMALL BUSINESS SET ASIDES

The widespread use of contracting to further social policies emerged after the 1930s.<sup>5</sup> As the Federal Government became a more prominent purchaser

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3. Indeed, very little debate about the merits of set asides can be found in the legislative history of any of the Small Business Acts.

4. The legislative histories of the Small Business Acts contain very little language that could be called a justification. It appears that no member of Congress felt the need to justify small business set asides, largely because such programs have gone unquestioned. Thus, the three justifications reflect themes that have resonated throughout the enactment of these laws. It is the hypothesis of this note that if one were to question the prudence of small business set asides, these would be the justifications given by their supporters.

5. Miller, *supra* note 1, at 28. This increase was due largely to an expansion of federal power resulting from increased judicial deference to Congress's power to regulate interstate commerce and the tremendous growth in federal purchasing associated with the New Deal. *Id.*

in the private marketplace, attaching collateral conditions to procurement contracts became a more effective and therefore more widely utilized tool for effecting socioeconomic policy.<sup>6</sup> Before the New Deal, government aid to small businesses consisted of regulating large businesses' conduct through antitrust laws.<sup>7</sup> While there were Depression era and wartime efforts to aid small businesses, such efforts met with limited success.<sup>8</sup> It was not until after the Second World War that Congress expanded upon earlier efforts to use federal procurement policies to aid small businesses directly through the 1953 Small Business Act<sup>9</sup> (1953 Act).<sup>10</sup>

The legal justification for small business set asides stems from the "fair proportion" language of the 1953 Act and Small Business Act of 1958<sup>11</sup> (1958 Act), implemented in procurement regulation FAR 19.5.<sup>12</sup> The term "fair proportion" appeared prior to the 1953 Act, but it was never defined and no instruction was given on implementing such language.<sup>13</sup> It was the novel interpretation of the 1958 Act's "fair proportion" language that dramatically altered small business procurement policy.

After repeating the 1953 Act's interest in mobilization, the 1958 Act went on to state:

[S]mall-business concerns . . . shall receive any award . . . as to which it is determined by the Administration and the contracting procurement or disposal agency . . . (3) *to be in the interest of assuring that a fair proportion of the total purchases and contracts for property and services for the Government in each industry category are placed with*

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6. *Id.*

7. See SANDRA M. ANGLUND, *SMALL BUSINESS POLICY AND THE AMERICAN CREED* 26–27 (2000).

8. During the Great Depression, Second World War, and Korean War, Congress created several unsuccessful programs designed to aid small business and increase their participation in the war effort. These programs have been criticized for doing more to aid large businesses than their smaller counterparts. See 99 CONG. REC. 6,143 (1953) (statement of Rep. Philbin); MANSEL G. BLACKFORD, *A HISTORY OF SMALL BUSINESS IN AMERICA* 97–98 (2d ed., Univ. of N. Carolina Press 2003).

9. Small Business Act of 1953, Pub. L. No. 83-163, 67 Stat. 232.

10. Although a reflection of prior programs, the 1953 Act was unique in its creation of an independent executive agency, the Small Business Administration (SBA), dedicated solely to the interests of small business owners. See ANGLUND, *supra* note 7, at 7–8.

11. Small Business Act of 1958, Pub. L. No. 85-536, 72 Stat. 384 (codified as amended, 15 U.S.C. § 631a (2000)) ("It is declared policy of the Congress . . . to insure that a fair proportion of the total purchases and contracts for property and services . . . be placed with small-business enterprises. . .").

12. FAR 19.502-1(a)(2) ("The contracting officer shall set aside an individual acquisition or class of acquisitions for competition among small businesses when—[.] (2) Assuring that a fair proportion of Government contracts in each industry category is placed with small business concerns; and the circumstances described in 19.502-2 or 19.502-3(a) exist.").

13. Congress failed to define "fair proportion" in the six separate statutes including such language: The Armed Services Procurement of 1947, The Selective Service Act of 1948, The Federal Property and Administrative Services Act of 1949, the Small Business Act of 1953, and the Small Business Act of 1958. See Albert Schreiber, *Small Business and Government Procurement*, 29 LAW & CONTEMP. PROBS. 390, 396 (1964); Miller, *supra* note 1, at 44.

*small-business concerns, or (4) to be in the interest of assuring that a fair proportion of the total sales of Government property be made to small-business concerns. . . .*<sup>14</sup>

Such language was revolutionary. The 1953 Act had only authorized set asides where the Small Business Administration (SBA) and the contracting agency agreed that such a reservation for small businesses served the interests of mobilization and national defense.<sup>15</sup> The 1958 Act's use of set asides was a novel means of ensuring that an undefined "fair proportion" of contracts would be awarded to small businesses. Thus, in 1958 the small business set aside changed from procurement tool intended to benefit the Government to one intended to benefit small businesses themselves.<sup>16</sup> This shift in beneficiary has had profound and lasting effects on the nature of small business procurement policy.<sup>17</sup>

After 1958 some questioned whether small businesses could get their fair proportion under the present procurement system. These critics believed the nature of federal procurement, which primarily involved the purchase of "major systems" requiring large capital investments and capabilities, made it virtually impossible for small business to receive the mandated fair proportion through full and open competition.<sup>18</sup> Proponents of limiting full and open competition argued that if small businesses had a competitive disadvantage in competing for "major systems" contracts, a disproportionate amount of non-"major systems" contracts should be awarded to small businesses.<sup>19</sup> This idea was reflected in the 1978 Amendment<sup>20</sup> to the 1958 Act (1978 Act).<sup>21</sup>

14. 15 U.S.C. § 644(a) (2000) (emphasis added). This new language was added by a Senate amendment to the original House bill that retained the 1953 Act's language. Small Business Act of 1958, Pub. L. No. 85-536, 72 Stat. 384, 395; H.R. REP. NO. 85-2135, *reprinted in* 104 CONG. REC. 13,384 (1958) (Conf. Rep.).

15. Small Business Act of 1953, Pub. L. No. 83-163, § 214, 67 Stat. 232, 238 ("[S]mall-business concerns within the meaning of this title shall receive any award or contract . . . as to which it is determined by the Administration and the contracting procurement agency (A) *to be in the interest of mobilizing the Nation's full productive capacity, or (B) to be in the interest of war or national defense programs.*") (emphasis added); *see also* 1947 Armed Services Procurement Act, 10 U.S.C. § 2301 (1958) (repealed by Pub. L. No. 103-355), which used fair proportion language and only authorized set asides for mobilization and emergency purposes.

16. *See* Arthur Miller & W. Theodore Pierson Jr., *Observations on the Consistency of Federal Procurement Policies with Other Government Policies*, 29 LAW & CONTEMP. PROBS. 277, 296 (1964).

17. Sen. Lowell Weicker expressed a similar shift in focus away from governmental interests regarding section 8(a) set asides: "[P]rice competitiveness of a firm is a distant second to the consideration of developmental needs of the small business." 124 CONG. REC. 29,646 (1978).

18. 49 Fed. Reg. 40,135 (Oct. 12, 1984); Fredric T. Suss, *Set-Asides and Certificates of Competency. Positive Programs for Small Business in Government Procurement*, 29 LAW & CONTEMP. PROBS. 418, 420 (1964) ("If small business is to be preserved . . . the factors of reduced potential and contracting personnel reluctance must be counteracted. Two programs aimed in this direction are the small business set-aside program and the certificate of competency program.").

19. *See* 49 Fed. Reg. 40,135 (Oct. 12, 1984).

20. The language contained in the 1978 Act regarding small business set asides is derived from and identical to the proposed Small Business Expansion and Simplification Act of 1977 (Small Business Expansion Act). S. 2259, 95th Cong. § 101 (1977).

21. "[The Small Business Expansion Act] if enacted into law, would be a major step forward in translating into action the mandate that . . . 'a fair proportion [of government contracts] be placed with small business-enterprise.'" 123 CONG. REC. 35,799 (1977) (statement of Sen. Nelson).

In addition to creating set asides for minority-owned small businesses, a topic that dominated the congressional debate and discussion of this law, the 1978 Act mandated that “[e]ach contract for the procurement of goods and services which has an anticipated value of less than \$10,000...shall be reserved exclusively for small business concerns.”<sup>22</sup> This set aside framework remains today.<sup>23</sup>

### III. THE COSTS OF SMALL BUSINESS SET ASIDES

Like other socioeconomic procurement policies, small business set asides run counter to many fundamental principles and systematic objectives of government contracting.<sup>24</sup> By its very definition, a set aside places a limit on full and open competition, creates a potential for increased individual contract prices and administrative costs, and reduces the natural advantages of the free market. The comptroller general’s decision in *Society Brand, Inc.* illustrates the acceptance of these increased costs.<sup>25</sup> After *Society Brand*, the Government is allowed, and in some cases required, to pay a premium price to contract with a small business. That premium is passed on to the American taxpayer.<sup>26</sup>

FAR 19.502-2(a) requires a contracting officer to determine whether two or more small businesses exist offering proposals that do not exceed market price, quality, and delivery, but the provision does nothing to define these terms. Indeed, the vagueness of these terms, combined with the possible willingness of large companies to offer a proposal below market price, at a higher quality, or on a more favorable delivery schedule, underscores the uncertainty of set-aside policies.<sup>27</sup>

Finally, set asides may have the harmful effect of propping up small businesses that would naturally fail due to their own inherent weaknesses; this

22. Pub. L. No. 95-507, § 221(j), 92 Stat. 1757, 1771 (1978).

23. Today Congress has established a governmentwide small business set aside “goal” of 23 percent, including all permutations of small business interests. 15 U.S.C. § 644(g)(1) (2000). Additionally, 15 U.S.C. § 644(j) raised the set-aside threshold from its 1978 \$10,000 level to all contracts worth between \$2,500 and \$100,000.

24. For a list of the objectives of government contract law, see Steven L. Schooner, *Desiderata: Objectives for a System of Government Contract Law*, 11 PUB. PROCUREMENT L. REV. 103, 103 (2002); Christopher R. Yukins, *Making Federal Information Technology Accessible: A Case Study in Social Policy and Procurement*, 33 PUB. CONT. L.J. 667, 697 (2004) (“All of these competing priorities [socio-economic policies] have long placed an enormous burden on the system, in terms of costs, complexity, and ultimately irreconcilable conflicts between the Government’s many procurement goals.”); Steven L. Schooner, *Buying the “Black Beret”: Balancing Customer “Needs” and Socio-Economic Policies*, 43 GOV’T CONTRACTOR ¶ 158 (2001); Steven L. Schooner, *Fear of Oversight: The Fundamental Failure of Businesslike Government*, 50 AM. U. L. REV. 627, 719–20 (2001) (“There seems little doubt that the government would be more businesslike and could work better...if buyers were unencumbered by congressionally mandated social policies.”).

25. See, generally, *Society Brand, Inc.*, 55 Comp. Gen. 475, 75-2 CPD ¶ 327 (1975).

26. *Id.*

27. Suss, *supra* note 18, at 425 (“The question of ‘unreasonable prices’ is one that cannot be resolved by the application of a precise formula...bid prices for non-commercial items tend to vary with each procurement depending on many factors...”). Because large businesses are foreclosed from the competition, no one can ascertain what price they would have offered.

effectively reduces the quality of goods and services offered to the Government and damages the national economy as a whole.<sup>28</sup>

#### IV. REEXAMINING THE JUSTIFICATIONS FOR SMALL BUSINESS SET ASIDES

Even advocates of small business set asides acknowledge that such programs come at a cost but argue the costs are justified by the benefits. While small business set asides are legally justified by the “fair proportion” language of the Small Business Acts of 1953, 1958, and 1978, one must look beyond the concept of “fairness” to determine whether these programs are truly warranted. Several largely unquestioned justifications have been asserted in support of set asides. Investigation of these justifications reveals their failure to fully justify the potential costs of the set asides.

##### A. *Reexamining the Values Justification for Small Business Set Asides*

Historian Mansel Blackford wrote, “If small businesses have been vital to America’s economic development, they have perhaps been even more important as a component of American culture.”<sup>29</sup> To many Americans, the small business is the embodiment of unique “small business values” including competition, entrepreneurship, rugged individualism, and opportunity.<sup>30</sup> This perception and the American affinity for the small business are some of the driving justifications and sources of continued political support for small business set asides.

Given this American affinity, it is no surprise that extolling the virtue of the small businessperson and “small business values” played an important role in the passage of the 1953, 1958, and 1978 Acts.<sup>31</sup> Advocating for the passage of the 1953 Act, Representative Harold Donohue called the small business sector “an essential patriotic artery of our productive body and in our survival as a free democratic people.”<sup>32</sup> One supporter of the 1958 Act went so far as to equate the promotion of small business values with the fight against

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28. Veronique de Rugy, *Are Small Businesses the Engine of Growth?* 15 (Am. Enter. Inst. for Pub. Pol’y Res., Working Paper No. 123, 2005), available at [http://www.Aei.org/docLib/20051208\\_WP123.pdf](http://www.Aei.org/docLib/20051208_WP123.pdf).

29. Mansel G. Blackford, *Small Business in America: A Historiographic Survey*, 65 BUS. HIST. REV. 1, 8 (1991).

30. See George L. Priest, *Small Business, Economic Growth, and the Huffman Conjecture*, 7 J. SMALL & EMERGING BUS. L. 1, 2 (2003).

31. “It [the small business] is, in truth, the symbol of free opportunity and the American vehicle for freedom of enterprise, initiative and individual economic action in our Nation.” 99 CONG. REC. 6,143 (1953) (statement of Rep. Philbin). “Small business is a necessary part of every community, indeed, really the foundation of every community.” 104 CONG. REC. 12,802 (1958) (statement of Sen. Saltonstall).

32. 99 CONG. REC. 6154 (1953).

communism.<sup>33</sup> Even as the nation's economy was deemphasizing the role of the small business, social affinity for the idea of the small businessperson continued to drive federal procurement policies.<sup>34</sup>

Today the promotion of small business values remains a justification for continuing small business set asides. Proponents continue to argue that such policies are necessary to "preserve the 'social and cultural values' associated with small-scale enterprise."<sup>35</sup> President Bush repeated this sentiment, stating:

Small business embodies so much of what America is all about. Self-reliance, hard work, innovation, the courage to take risks for future growth: these are values that have served our Nation well since its very beginning. They are values to be passed on from generation to generation. We must ensure that our small businesses continue to thrive and prosper, not just for their own sakes, but for all of us.<sup>36</sup>

SBA critic Veronique de Rugy noted, "It seems like mother, apple pie, and small business is the trilogy of great things that everyone worships."<sup>37</sup>

While the impact small business values have had on American culture is undeniable, it is questionable whether set asides can actually promote these values by awarding contracts based solely on business size. While some beneficiaries of small business set asides will reflect the sought-after values, others will not. Although FAR 19.502-2(a) sets certain criteria for awarding a set-aside contract, these do not include a determination of the values expressed by the potential contractors. Thus, the set-aside program does not distinguish between small businesses that embody the requisite values and those that do not in awarding contracts.<sup>38</sup> Although the promotion of small business values played a role in justifying small business set asides, little to no effort has been made to ensure that these values have been advanced.

One of the purposes of the 1953 Act was "[t]o make small-business concerns sound and self-sufficient."<sup>39</sup> Examination of this justification, however, raises the question whether such a paternalistic government program can foster and encourage the self-reliance, entrepreneurship, innovation, and independence that set asides are designed to promote. Indeed, there is a strong argument that set asides inhibit these values by making small businesses largely dependent

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33. "If we do that [promote small businesses], we need not ever worry about the future of the people on main streets of America.... Our people will not have leanings toward socialistic type governments, because any man who has the right and responsibility of a business of his own will never turn to the philosophy of a socialistic-type government." 104 CONG. REC. 12,801 (daily ed. July 1, 1958) (statement of Sen. Thyne).

34. Miller, *supra* note 1, at 45.

35. JONATHAN J. BEAN, *BIG GOVERNMENT AND AFFIRMATIVE ACTION: THE SCANDALOUS HISTORY OF THE SMALL BUSINESS ADMINISTRATION* 29 (2001).

36. Press Release, The White House, Message to the Congress of the United States (Nov. 19, 2002), available at <http://www.whitehouse.gov/news/releases/2002/11/20021125-8.html>.

37. Stacy Perman, *A Talk with a Small-Biz Heretic*, BUSINESSWEEK, Dec. 19, 2005, available at [http://www.businessweek.com/smallbiz/content/dec2005/sb20051219\\_495192.htm](http://www.businessweek.com/smallbiz/content/dec2005/sb20051219_495192.htm).

38. de Rugy, *supra* note 28, at 14.

39. 99 CONG. REC. APP. A1379 (statement of Rep. Hill).



on the Government. Thus, it seems contradictory to use set asides to promote small business independence and self-sufficiency.

Set asides also raise the more philosophically difficult question of whether the federal procurement system's proper role includes the promotion of "small business" values. The primary purpose of the federal procurement system is to acquire goods and services for the Government—not to promote certain values. Using set asides to promote small business values can violate that primary purpose of government contracting.<sup>40</sup> Additionally, the Government has myriad other programs to promote small businesses and the values they embody, which do not violate the primary purposes of the procurement system.<sup>41</sup> Because the set-aside system does nothing to ensure that small business values are actually promoted, its effectiveness at promoting those values is questionable. Less-intrusive means to encourage those values exist and concerned members of the procurement community should question the validity of the values justification relative to set asides' additional costs.

#### B. *Reexamining the Economic Justification for Small Business Set Asides*

The economic justifications for small business set asides derive from the argument that small businesses, whose continued survival is constantly threatened by large businesses, serve as a vital pillar of the American economy.<sup>42</sup> From 1953, when Representative William S. Hill justified the Small Business Act by stating, "[i]t is time, however, that small business should be viewed...in its true perspective as the economic backbone of the Nation," politicians have capitalized on the idea that small businesses are the engines of economic growth.<sup>43</sup>

This argument was used to justify the 1953 Act,<sup>44</sup> 1958 Act,<sup>45</sup> and 1978 Act.<sup>46</sup> Today politicians on both sides of the aisle have embraced small business interests and used economic justifications for their continued support of small business set asides.<sup>47</sup>

40. See *supra* Section III.

41. The Small Business Administration is principally dedicated to promotion of small businesses.

42. 99 CONG. REC. APP. A1379 (1953) (statement of Rep. Hill); see generally *THE VITAL MAJORITY: SMALL BUSINESS IN THE AMERICAN ECONOMY* (Deane Carson ed., Small Business Administration, U.S. Government Printing Office 1973).

43. 99 CONG. REC. APP. A1379 (1953) (statement of Rep. Hill).

44. "[A] weak or deteriorating small business threatens the economic well-being of the country, and all the people[.]" *Id.* "I have always regarded small business to be the heart of our great American economic machine." 99 CONG. REC. 6,143 (1953) (statement of Rep. Philbin).

45. "Small business has always been and must continue to be the very heart and soul of the Nation's economy..." 104 CONG. REC. 12,808 (daily ed. July 1, 1958) (statement of Sen. Payne).

46. "This bill [the Small Business Expansion Act] is an expression of my deep conviction that the small business community...is, indeed, the backbone of the American economy..." 123 CONG. REC. 35,641, 35,798 (1977) (statement of Senator Nelson).

47. "Small businesses are the backbone of our growing economy." Sen. John F. Kerry, *Welcome*, Committee on Small Business & Entrepreneurship, <http://sbc.senate.gov> (last visited May, 28, 2007). "Small businesses have always been the backbone of our economy." Press Release, The White House, Message to the Congress of the United States (Nov. 19, 2002), *available at* <http://www.whitehouse.gov/news/releases/2002/11/20021125-8.html>.

The most recent incantation of the argument that small businesses are the engine of the American economy has centered on the hypothesis that they account for the overwhelming majority of job growth each year.<sup>48</sup> This argument became popular after the publication of David Birch's 1987 study *Job Creation in America*.<sup>49</sup> Although debate about the accuracy of such studies continues,<sup>50</sup> the "belief in small business as the 'engine' of economic growth continues to captivate policy makers."<sup>51</sup>

The SBA claims that small businesses represent 99.7 percent of all employer firms, employ 50 percent of all private sector employees, pay 45 percent of the total U.S. payroll, and account for 60–80 percent of new job growth in the past decade.<sup>52</sup> Claims that small businesses create "virtually all" of the nation's new jobs, are the leaders of innovation in the American economy, and provide unique opportunities for traditionally marginalized workers are regularly repeated in the president's State of Small Business Annual Reports.<sup>53</sup>

While these statistics are strong ammunition for supporters of small business set asides, they are misleading. First, there is the question of how to classify the "small business."<sup>54</sup> This classification can have a profound impact on the effect small businesses have on the total economy.<sup>55</sup>

Today the SBA determines size standards by industry-specific business earnings that can range from construction companies making under \$31,000,000

48. "They [small businesses] account for half of our gross domestic product, more than half our jobs, and three-fourths of new jobs created each year." Rep. Velazquez, *Welcome Message from the Chairwoman*, House Small Business Committee, <http://www.house.gov/smbiz/democrats/welcomemessage.htm>. "Small business represent 95% of all employers... and are responsible for creating three out of every four new jobs." Rep. Jim Moran, *Small Business*, [http://moran.house.gov/issues\\_smallbiz.shtml](http://moran.house.gov/issues_smallbiz.shtml) (last visited Apr. 18, 2007). See also de Rugy, *supra* note 28, at 1.

49. DAVID L. BIRCH, *JOB CREATION IN AMERICA: HOW OUR SMALLEST COMPANIES PUT THE MOST PEOPLE TO WORK* 14 (1987); see also DAVID L. BIRCH, *THE JOB GENERATION PROCESS* 29 (M.I.T. Program on Neighborhood and Regional Change 1979); David L. Birch, *Who Creates Jobs?* 65 *PUB. INT.* 3, 3–14 (1981).

50. For a detailed analysis of the fallacies of SBA job creation statistics, see de Rugy, *supra* note 28, at 8 (citing STEVEN J. DAVIS ET AL., *JOB CREATION AND DESTRUCTION* 65 (1996)); see also Steven J. Davis et al., *Small Business and Job Creation: Dissecting the Myth and Reassessing the Facts* (Nat'l Bureau of Econ. Research, Working Paper No. 4492, Oct. 1993); Bruce A. Kirchhoff & Patricia G. Greene, *Response to Renewed Attacks on the Small Business Job Creation Hypothesis*, in *FRONTIERS IN ENTREPRENEURSHIP RESEARCH* 1995 (1995), available at <http://www.babson.edu/entrep/fer/papers95/kirchof.htm> (last visited Apr. 18, 2007).

51. *Who Needs the SBA? An Historical Perspective on the Small Business Administration: Hearing Before S. Subcomm. on Financial Management of the S. Comm. on Homeland Security and Governmental Affairs*, 109th Cong. 4 (2006) (statement of Professor Jonathan Bean), available at [http://coburn.senate.gov/ffm/index.cfm?FuseAction=Files.View&FileStore\\_id=506564bb-2233-4fce-b276-39ff14f8d7c7](http://coburn.senate.gov/ffm/index.cfm?FuseAction=Files.View&FileStore_id=506564bb-2233-4fce-b276-39ff14f8d7c7).

52. U.S. Small Business Administration, *Frequently Asked Questions*, <http://app1.sba.gov/faqs/faqindex.cfm?areaID=24> (last visited May 8, 2007); see also *Oversight of SBA Entrepreneurial Programs and Recommendations for Change: Hearing Before H. Subcomm. on Workforce Empowerment and Government Programs of the H. Small Business Comm.*, 109th Cong. 1 (2006) (statement of Rep. Nydia M. Velázquez), available at <http://www.house.gov/smbiz/democrats/Statements/2006/st030206b.htm>.

53. Priest, *supra* note 30, at 2.

54. See de Rugy, *supra* note 28, at 7.

55. *Id.*

to agricultural companies making under \$750,000.<sup>56</sup> The manner in which the SBA classifies small businesses is integral to understanding the employment figures it quotes. When examined, statements like “Small firms with fewer than 500 employees represent 99.9 percent of the 25.8 million businesses [in America]”<sup>57</sup> add little to a true understanding of the impact of small businesses on the economy.<sup>58</sup>

Additionally, the employment figures quoted by the SBA say nothing about the kinds of jobs created or the wages and benefits employees receive, facts that are essential to understanding the economic impact of small businesses. For a true understanding of the role the small business occupies in the American economy, the myriad factors largely ignored by proponents of small business set asides must be considered.

The economic consequences of set asides have the potential to weaken their economic justification. Set asides have the potential to encourage inefficient use of resources and create an incentive for businesses to remain small.<sup>59</sup> When preferences are only given to firms that remain under a certain number of employees, there is an incentive for that firm *not* to hire new employees.<sup>60</sup> Thus, a policy meant to encourage job creation can have the reverse effect of inhibiting job growth.<sup>61</sup> Set asides’ discouragement of efficient use of resources also can decrease the natural market forces that regulate the economy.<sup>62</sup>

The underlying economic justification for small business preferences, that small businesses are the engine of job creation in this country, is questionable.<sup>63</sup> While the role of the small business in creating employment is undeniable, this evidence only serves to undermine the asserted economic justifications of small business set asides.<sup>64</sup> Almost every economic argument used to justify

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56. U.S. SMALL BUSINESS ADMINISTRATION, TABLE OF SMALL BUSINESS SIZE STANDARDS MATCHED TO NORTH AMERICAN INDUSTRY CLASSIFICATION SYSTEM CODES 1, 4, *available at* <http://www.sba.gov/size/sizetable2002.pdf>.

57. U.S. Small Business Administration, Frequently Asked Questions, <http://appl.sba.gov/faqs/viewResultFaq.cfm?faqID=485> (last visited Apr. 20, 2007).

58. A simple example illustrates the insignificance of the raw statistics about small businesses as a percentage of national employers quoted by small business proponents. If there are one hundred people in a room, forty who own their own businesses and employ only themselves and sixty who are evenly divided among three companies, each employing twenty people, although the number of small businesses (*i.e.*, businesses employing fewer than twenty people) account for 93 percent of the room’s employers, these businesses collectively employ only 40 percent of the room’s population. While the three large companies employ the remaining 60 percent, they only make up 7 percent of the total number of businesses in the room.

59. Priest, *supra* note 30, at 10; *see also* de Rugy, *supra* note 28, at 1.

60. Schreiber, *supra* note 13, at 402.

61. de Rugy, *supra* note 28, at 1.

62. *Id.*; *see also* Priest, *supra* note 30, at 10.

63. Even within the SBA some have criticized the data because they “often lack the timeliness that would make them useful for policy analysis.” U.S. SMALL BUSINESS ADMINISTRATION, THE SMALL BUSINESS ECONOMY: A REPORT TO THE PRESIDENT 13 (2005), *available at* [http://www.sba.gov/advo/research/sb\\_econ2005.pdf](http://www.sba.gov/advo/research/sb_econ2005.pdf). *See also* de Rugy, *supra* note 28, at 1.

64. One argument is noticeably absent from set-aside proponents: if small businesses are such a vital force in the national economy, why do they require preferential governmental treatment?

the small business set asides could be used to justify preferential treatment for large businesses.<sup>65</sup> Because of the inconstancies in the economic data and the inconsistent use of those data, concerned members of the procurement community should be cautious about putting too much faith in the economic justifications for set asides. The American public deserves a more accurate picture of the role of small businesses in job creation before such figures are called upon to justify programs that have the potential to raise the expense of contracts and undermine the traditional values that have underscored federal procurement policy.

### C. *Reexamining the Competitive Justifications for Small Business Set Asides*

Full and open competition plays a central role in America's economic system and is a central goal of the procurement process.<sup>66</sup> Belief in the merits of competition is ingrained in the American business psyche. Thus, not surprisingly, competition rhetoric plays a large, if not ironic, role in justifying small business set asides.<sup>67</sup> The 1953 Act equated the maintenance of free competition with the assurance of national security.<sup>68</sup> Section 2 of the 1958 Act clearly recognized the importance of competition to the national economy and used competition as a primary justification for federal aid to small businesses.<sup>69</sup> A 1980 amendment to the Small Business Act inserted language stating congressional commitment to fostering small business interests "for the purpose of preserving and promoting a competitive free economic system."<sup>70</sup>

The competitive justification for small business set asides has roots in the Great Depression and the Second World War. Sandra Anglund hypothesized that these events' lasting impact on small business was the sentiment that small businesses became victims of government policies and were "inherently disadvantaged" compared to big businesses; they were thus made worthy of extraordinary government protections and preferences.<sup>71</sup> As the 1953

65. For example, if small businesses deserve preferential treatment for employing half of private sector employees, why do large businesses not deserve equally preferential treatment for employing the other half?

66. FAR 1.102; S. REP. NO. 103-258, at 2 (1994), as reprinted in 1994 U.S.C.C.A.N. 2561, 2562.

67. "The essence of the American economic system of private enterprise is free competition." Small Business Act of 1953, Pub. L. No. 83-163, 67 Stat. 232; see also Small Business Act of 1958, Pub. L. No. 85-536, 72 Stat. 384 (codified as amended 15 U.S.C. § 631 (2000)).

68. "The preservation and expansion of such competition is basic not only to the economic well-being but to the security of the Nation." Small Business Act of 1953, Pub. L. No. 83-163, 67 Stat. 232.

69. "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." Small Business Act of 1958, Pub. L. No. 85-536, 72 Stat. 384.

70. 15 U.S.C. § 631a(a) (2000).

71. See ANGLUND, *supra* note 7, at 36-37; see *id.* at 29 for a quotation of President Roosevelt's 1938 antimonopoly message to Congress: "Bigger Business... has larger opportunity to grow still bigger at the expense of smaller competitors who are weakened by financial adversity."

Act,<sup>72</sup> 1958 Act,<sup>73</sup> 1978 Act,<sup>74</sup> and subsequent set-aside policies demonstrated, Congress adopted this view.

The theory that underlies the competitive justification for small business set asides—that small businesses cannot compete with large businesses for federal contracts—demands reexamination. This theory was reflected in and reinforced by the 1953 Act and the 1958 Act.<sup>75</sup> In addressing the legislative purpose behind these statutes, the Fifth Circuit noted: “The [Small Business Act] is based on the premise that such [small] firms are unable to compete effectively in the marketplace and therefore cannot secure government procurement contracts awarded through competitive bidding.”<sup>76</sup>

This theory is flawed because it fails to take into account two major factors. First, such a statement ignores all of the natural advantages that small businesses have over larger firms in certain contexts. Small businesses have lower overhead costs. They lack the large bureaucratic structures of a large firm and do not need to pass along such costs in their contract bids.<sup>77</sup> Second, small firms are more likely to practice and benefit from innovative business techniques.<sup>78</sup> These advantages became evident in the 1970s and 1980s when small businesses demonstrated an ability to weather the economic storms that had so severely damaged larger businesses.<sup>79</sup>

72. “For the New Deal and Fair Deal of the last 21 years have done more to foster monopoly and prevent the growth of smaller businesses, and thus to aid so-called big business to bigger gains, than all the Republican administrations in history.” 99 CONG. REC. APP. A339 (1953) (statement of Rep. Curtis). “We must be exceedingly careful never to permit great corporate organizations... to oppress or injure our small-business interests.” 99 CONG. REC. 6,143 (1953) (statement of Rep. Philbin).

73. “It is quite obvious to me... that without the special assistance made possible [by the SBA], the growing power of monopoly, public indifference, and... procurement officials who prefer to work with the great corporations, would make it difficult for the American small business to survive at all.” 104 CONG. REC. 12,810 (1958) (statement of Sen. Humphrey).

74. “[Passage of the Small Business Expansion Act] would help counteract the seeming reluctance of many procuring agencies to do business with smaller firms, turning around the ‘bigger is better’ syndrome of Government procurement.” 123 CONG. REC. 35,800 (1977) (statement of Sen. Hathaway).

75. “[It is] clear that Congress intended these statutes [the Small Business Act of 1958 and subsequent amendments] as a means to protect small businesses from the ravages of unchecked competition...” *Rutter Rex Mfg. Co., Inc. v. United States*, 706 F.2d 702, 707 (5th Cir. 1983).

76. *Id.* at 708 (citing *Ray Baillie Trash Hauling, Inc. v. Kleppe*, 477 F.2d 696, 708 (5th Cir. 1973)).

77. Congressional small business advocates noted that “small businesses routinely do this [government contract] work ‘faster, better and cheaper’ than their corporate counterparts. That’s because they are more agile, more innovative, more concerned with cost containment, accustomed to smaller profit margins, and maintain less overhead than the giants that replace them.” HOUSE SMALL BUSINESS COMMITTEE DEMOCRATS, 2002 SCORE CARD III: SMALL BUSINESSES: OPPORTUNITY DENIED 2 (2002) available at [http://www.house.gov/smbiz/democrats/Scorecard\\_III.pdf](http://www.house.gov/smbiz/democrats/Scorecard_III.pdf).

78. “In the past, when we have needed innovation—small businesses have been the ones to deliver it.” *Oversight of SBA Entrepreneurial Programs and Recommendations for Change: Hearing Before H. Subcomm. on Workforce Empowerment and Government Programs of the H. Small Business Comm.*, 109th Cong. 1, available at <http://www.house.gov/smbiz/democrats/Statements/2006/st030206b.htm>; see also de Rugy, *supra* note 28, at 13.

79. Christopher Conte, *Small Business in American History*, EJournal USA, <http://usinfo.state.gov/journals/ites/0106/ijee/conten.htm> (last visited Apr. 18, 2007).

If given the opportunity, the natural advantages enjoyed by many small businesses may allow them to compete and win against larger firms for certain contracts.<sup>80</sup> This is especially true for smaller procurements where, due to the size of award, many large firms may be reluctant to even attempt to compete.<sup>81</sup> Writing from experience as both a small business owner and professor, Albert N. Schrieber noted, “[b]uyers and procurement officers tend to prefer to place orders with small...firms...because small businessmen are often more cooperative, easier to deal with, and will allow the buyer greater access to information regarding their operations.”<sup>82</sup> Small businesses also share advantages when competing for regional contracts where simply being in the area provides the greatest natural advantage. Unfortunately, because set asides eliminated the competition necessary to test the effectiveness of these advantages, the assumption that small business cannot compete goes unchallenged.

Another largely unchallenged assumption underlying small business set asides is the appropriateness of using the federal procurement system to correct the perceived competitive disadvantages of small businesses. Set asides naturally reduce the role of the free market in determining the success and failure of many small businesses. The free market and its natural drive towards competition forces businesses to allocate resources in an efficient and effective manner.<sup>83</sup> The set aside, however, reduces the natural merit system of the open market and subsidizes inefficient and ineffective businesses that would otherwise fail.<sup>84</sup>

Perhaps most distressing is that, by limiting the ability of large businesses to compete for certain contracts, the Government effectively punishes success. Even arguments claiming that preferences are necessary to foster small business growth and increase overall competition seem contradictory; as small businesses grow larger, they are punished.<sup>85</sup> Thus, set asides may encourage businesses to remain small, counterbalancing market forces that encourage growth.

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80. In fact, a supporter of the 1958 Act, Rep. John Patman stated, “It seems probable, furthermore, that a large percentage of these set asides would inevitably go to small firms anyway.” 104 CONG. REC. 13,385 (1958).

81. One small business website cleverly summed up this fact by stating, “the (Tennessee) Titans don’t play your high school’s team. There’s not enough money in it for them and the high school team has its own fans.” Thus, this website encourages small businesses to compete in markets that large businesses may not find it prudent to compete in. Giving aid to small businesses to thrive in niche markets has become almost a cottage industry on the Internet. *Small Business, Big Competition*, ABCs OF SMALL BUSINESS, [http://www.abcsmallbiz.com/bizbasics/marketing/smallbiz\\_bigcomp.html](http://www.abcsmallbiz.com/bizbasics/marketing/smallbiz_bigcomp.html) (last visited Apr. 18, 2007).

82. Schrieber, *supra* note 13, at 403.

83. See de Rugy, *supra* note 28, at 15.

84. For a related illustration about how preferential government lending programs interfere with the natural forces of the open market, see *The Effectiveness of the Small Business Administration: Hearing Before S. Comm. on Homeland Security and Governmental Affairs*, 109th Cong. 15 (2006) (written testimony of Veronique de Rugy), available at [http://coburn.senate.gov/ffm/index.cfm?FuseAction=Files.View&FileStore\\_id=9c296e55-faec-44aa-b691-cee17031a7c4](http://coburn.senate.gov/ffm/index.cfm?FuseAction=Files.View&FileStore_id=9c296e55-faec-44aa-b691-cee17031a7c4).

85. See Schrieber, *supra* note 13, at 402.

The competitive justification for small business set asides is both driven by and reflected in the rhetoric of small business interests. In the past, small business's demand for open competition drove government antitrust policies. Later, the demand for a "fair proportion" of competition drove the set-aside policy. Today, the demand for more competition has caused the small business community to support competitive sourcing, forcing government employees to compete with private companies to perform previously in-house functions and to denounce the use of commercial items in federal procurement.<sup>86</sup>

Not all small business rhetoric has embraced open competition. First, the set-aside programs championed by the small business community allow small businesses to avoid competing with big business entirely. Second, history has shown infighting among the small business community, especially concerning the more controversial procurement policies such as affirmative action.<sup>87</sup> For example, during the Reagan administration, when it appeared that affirmative action in contracting was most vulnerable, there was pressure from some within the small business community to abolish such programs.<sup>88</sup> Indeed, there has been a continuing trend toward reducing and eliminating set-aside programs for minority-owned small businesses.<sup>89</sup> Ironically, whereas small business set asides predate minority-owned business set asides by almost twenty years and garner the lion's share of set-aside contracts, racially based set asides have garnered more political attention.<sup>90</sup> In addition to affirmative action, some groups have advocated ending procurement programs designed to support the federal prison industries<sup>91</sup> and measures aimed at aiding tax-exempt rural electric coops, all in the name of increasing competition.<sup>92</sup>

For many small business advocates, competition in procurement is a good thing, as long as it does not make small business compete with large business or

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86. *Use Market Efficiencies to Provide Best Services for Government*, NAT'L FED'N OF INDEP. BUS., [http://www.nfib.com/page/competitiveContracting?\\_templateId=315](http://www.nfib.com/page/competitiveContracting?_templateId=315) (last visited Apr. 18, 2007). "We [the small business community] are also concerned because a preference for purchasing commercial items in the proposed legislation [FASA] would override the Competition in Contracting Act and justify noncompetitive procurement..." *Hearing on H.R. 2238, H.R. 3586 and S. 1587 Before the H. Subcomm. on Procurement, Taxation and Tourism of the H. Comm. on Small Business*, 103d Cong. 121 (1994) (statement of Paul J. Seidman), available at 1994 WL 213757.

87. "[T]hese goals [of minority set asides] ... sometimes serve to siphon government business away from small businesses that are not also 'disadvantaged.' ... preferences designed to increase the share of procurement dollars devoted to SDBs [small disadvantaged businesses] remove[ ] this subset of awards from non-SDB small businesses." Major Patrick E. Tolan, Jr., *Government Contracting with Small Businesses in the Wake of Federal Acquisition Streamlining Act, The Federal Acquisition Reform Act, and Adarand: Small Business as Usual?* 44 A.F. L. REV. 75, 77 (1998).

88. BEAN, *supra* note 35, at 113.

89. SMALL BUSINESS ADMINISTRATION, *THE SMALL BUSINESS ECONOMY: A REPORT TO THE PRESIDENT 98* (2005), available at [http://www.sba.gov/advo/research/sb\\_econ2005.pdf](http://www.sba.gov/advo/research/sb_econ2005.pdf).

90. Interestingly, many of the same arguments used to denounce race-based set asides apply equally to their size-based counterparts. JOHN DAVID SKRENTY, *THE IRONIES OF AFFIRMATIVE ACTION: POLITICS, CULTURE, AND JUSTICE IN AMERICA* 36-37 (1996).

91. *What We Lobby for: Competitive Government Contracting: Federal Prison Industries*, NAT'L FED'N OF INDEP. BUS., <http://www.nfib.com/page/FPI.html> (last visited Apr. 20, 2007).

92. *National Agenda: Competition*, NAT'L FED'N OF INDEP. BUS., <http://www.nfib.com/page/competitionHome.html> (last visited May 8, 2007).

with other beneficiaries of socioeconomic procurement programs. C. Wright Mills summarized this situation, stating, “[i]n the abstract political ranges, everyone can believe in competition; in the concrete economic case, few small entrepreneurs can afford to do so.”<sup>93</sup>

As has been demonstrated above, the unchallenged assumption that small businesses cannot compete with large businesses may not be true. Additionally, there is a clear contradiction in the competition rhetoric of small business interests. These factors cast doubt on the validity of the competitive justification. Congress noted that “[c]ompetition requirements have been enacted to obtain low prices, avoid favoritism and conflict of interest, and provide offerors with a fair chance to compete for government contracts.”<sup>94</sup> Policies are needed that increase competition on all levels, not decrease competition on some. When policies do limit competition, they should be strictly scrutinized by policymakers and concerned members of the procurement community.

## V. CONCLUSION

In 1964, Arthur Miller highlighted “the federal contract as a device of great flexibility which in its total impact has important consequences for the manner in which the values of the American people are shaped and shared.”<sup>95</sup> This remains as true today as it was in 1964. Procurement set asides are so tied to our view of American values that meaningful reform is difficult no matter how inconsistent with those values set asides have become.<sup>96</sup> However, Professor Miller also argued that “[t]he social usefulness of the federal contract should not bar continuing analyses in political and economic terms.”<sup>97</sup>

There is clear tension between the justifications for set asides, American values, and traditional goals of the federal procurement system. The value, economic, and competitive justifications asserted for small business set asides do not satisfactorily justify these inconsistencies. Perhaps most disturbing, few seem interested in testing whether small business set-aside programs really further the goals reflected by their justifications.<sup>98</sup>

93. C. WRIGHT MILLS, *WHITE COLLAR: THE AMERICAN MIDDLE CLASSES* 36 (1951).

94. S. REP. NO. 103-258 (1994), as reprinted in 1994 U.S.C.C.A.N. 2561, 2562.

95. Miller & Pierson, *supra* note 16, at 314.

96. See de Rugy, *supra* note 28, at 15.

97. Miller & Pierson, *supra* note 16, at 314.

98. One cynical explanation for this congressional disinterest is the view that such policies are “a useful conduit for the constituent work of the Small Business Committees, a dumping ground for politicians, and a ‘petty cash drawer’ for the pet schemes of Congress.” *Who Needs the SBA? An Historical Perspective on the Small Business Administration: Hearing Before S. Subcomm. on Financial Management of the S. Comm. on Homeland Security and Governmental Affairs*, 109th Cong. \*7 (2006) (statement of Professor Jonathan Bean), available at [http://coburn.senate.gov/ffm/index.cfm?FuseAction=Files.View&FileStore\\_id=506564bb-2233-4fce-b276-39ff14f8d7c7](http://coburn.senate.gov/ffm/index.cfm?FuseAction=Files.View&FileStore_id=506564bb-2233-4fce-b276-39ff14f8d7c7).



This note is skeptical that the benefits of small business set asides outweigh their costs but does not flatly deny that set-aside programs may be justified. The problem is the lack of empirical evidence that would allow us to make such a judgment.<sup>99</sup> In the end, the extent to which Americans allow their Government to implement social policies through the appropriation of their money should be a fully informed decision.

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99. "To date, there is a lack of empirical evidence to demonstrate that social programs can prove effective without adversely impacting, at some level, other fundamental goals of the procurement system." Steven L. Schooner, *Mixed Messages: Heightened Complexity in Social Policies Favoring Small Business Interests*, 8 PUB. PROCUREMENT L. REV. CS78, CS83 (1999).