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**Small Business Contracting in the United States and Europe:
A Comparative Assessment**

1 March 2010

by

**Max Kidalov, Assistant Professor
Procurement Law & Policy**

Graduate School of Business & Public Policy

Naval Postgraduate School

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Prepared for: Naval Postgraduate School, Monterey, California 93943



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Abstract

The United States, the EU, and virtually all European nations undertook solemn commitments to promote small business access to public procurement and R&D programs as part of the *2000 OECD Bologna Charter on Small and Medium-sized Enterprises (SME) Policies*. Notwithstanding these mutual commitments, the Europeans have continued challenging America's *Small Business Act of 1953* and the set-asides it authorizes as unfair barriers to trade. Thus far, the United States has resisted the criticism. To put the transatlantic debate over small business contracting into concrete terms, this article compares European and US approaches to small business procurement assistance. Subjects of comparison include approaches to defining a small business concern; creation of small business procurement assistance agencies; availability of suitable contracts through reductions in bundling and consolidation; small business goals and set-asides; contracting with small firms for economic sustainability and remedial purposes; measures to enhance transparency and availability of public procurement information for small firms; small business subcontracting policies; and use of public procurement to stimulate innovation. The article notes that Europe is competing with the United States for best SME assistance policies. It concludes that the main elements of European and US policies to support SME access to public procurement and R&D are very similar and are continuing to further converge. Accordingly, EU trade complaints are without substantial merit. Indeed, both sides in this debate have legitimate reasons to help their small contractors, both sides have weaknesses in their SME policies, and both sides can learn from each other's best practices.

Keywords: Small business, small and medium enterprises, SMEs, procurement, government contracts, public contracts, set-asides, preferences, subcontracting, international trade, competition, innovation, comparative procurement policy, United States, European Union, defense industrial base, defense procurement, SBIR



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I. Introduction

On July 27, 2009, the European Commission (EC) issued its annual report, *United States Barriers to Trade and Investment Report for 2008*, where it once again republished its complaint that “small business set-aside schemes, exemplified by the Small Business Act of 1953” are discriminatory measures that “limit bidding opportunities for EU [or European Union] contractors” in the US procurement market (EC). The EC raised this same concern in at least two preceding editions of this annual report (EC). In light of this persistent complaint by our trading partners, US policymakers in Congress and the Executive Branch would be well-justified in considering broad questions of comity, such as the extent to which the Europeans themselves have adopted policies and practices that favor small EU firms in government procurement; the relative impact of these practices on the entry of US firms into the EU procurement system; the motives behind the US and EU small business preferences; the extent to which any EU small business practices are worth adopting in the US as part of procurement reforms; and implications of established small business preferences for future transatlantic trade relations.

As this paper demonstrates, small business has long held a special place in the Western public procurement systems both in Europe and in the United States. Public authorities on both sides of the Atlantic use the demand created by government contracts to stimulate competitive private entrepreneurship and greater economic development within their borders. Indeed, the United States, the EU’s predecessor (the European Community), EU members Austria, Belgium, Bulgaria, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, Netherlands, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, Sweden, and United Kingdom, and European Free Trade Area (EFTA) members Norway, Iceland, and Switzerland, are all signatories to the Organization for Economic Co-operation and Development’s *2000 Bologna Charter on Small and Medium-Sized Enterprises Policies*. The *Bologna Charter*



“recommend[s] that in developing SME policies [...] SME participation in public R&D programs and procurement contracts [should be] encouraged” (OECD, 2000).

Throughout the 20th and the early 21st centuries, the United States has been a global leader in small business-friendly procurement policies. However, such policies have also seen increasingly popularity with individual European countries, in pan-European institutions such as the European Space Agency, and with the highest authorities of the European Union, including the European Defense Agency and the European Commission itself. As it turns out, US and European small business preferences in contracting are driven by economic and policy concerns unrelated to foreign trade, such as countering monopolistic practices in one’s domestic industrial base, stimulating innovation, remedying past racial discrimination, or promoting employment in local distressed areas. To the extent that small business preferences are used to strengthen domestic industry for international competitiveness, this rationale is generally recognized as legitimate by European government authorities and learned commentators.

In 2003, both the United States and the combined European economies had gross domestic products (GDPs) roughly equal to \$11 trillion (EU, 2003). With admission of 12 new members since 2003, the EU now includes 27 countries: Germany, France, Italy, the Netherlands, Belgium, Luxembourg, Denmark, Ireland, United Kingdom, Greece, Spain, Portugal, Austria, Finland, Sweden, Czech Republic, Cyprus, Estonia, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, Slovakia, Bulgaria and Romania (EC). The EU’s GDP has further grown from \$14.34 trillion in 2006, to \$14.66 trillion in 2007, and to an estimated \$14.82 trillion in 2008 (“European Union,” 2010). In the United States, the GDP has further grown from \$13.83 trillion in 2006, to \$14.11 trillion in 2007, to an estimated \$14.29 trillion in 2008. Companies known in Europe as small and medium enterprises (SMEs) and known in the United States as small businesses or small business concerns (SBs or SBCs) account for approximately 65% of the European GDP and 45% of the US GDP (EARTO, 2004, October 1). US small businesses accounted for 50% of



private, non-farm GDP from 1998 through 2004, a decline from 58% in the 1950s (SBA Office of Advocacy, 2006, April 16). In the United States, small firms represent over 99% of all employers, provide over half the private-sector jobs, and generate over two-thirds of new jobs annually. US small business policies in favor of prime contracting resulted in contract awards that created or retained 654,114 jobs in Fiscal Year 2008, an increase from 562,000 jobs in Fiscal Year 2005 (SBA, 2009, February).

European small and medium-sized enterprises appear to be almost twice as represented in the European procurement market as US small businesses are in the US procurement market. European small firms received on average 42% of all prime contracting dollars subject to EU regulation in 2005 (EC, 2008b, June 25), while US small firms received slightly more than 23% of Federal prime contracting dollars for Fiscal Year 2005 (SBA). Within EU Member States, SME participation “range[d] from 78% and 77% in Slovenia and Slovakia to 35% and 31% in France and the U.K.” (EC, 2008b, June 25). These participation levels exceed US participation levels by a magnitude of anywhere from about 50% to almost 400%. The comparison is even less favorable to the US procurement system once it’s recognized that contracts subject to European regulation must be large enough to exceed EU thresholds. Currently, for central government entities, these thresholds are set at about EUR 125,000 for supplies and services, and EUR 4.845 million for public works, dropping further to EUR 80,000 and EUR 1 million whenever requirements are split into small lots, but increasing to EUR 193,000 for supplies and services procured by subnational and local authorities (UK Office, 2010, January 1). What’s more, the share of US small businesses in US procurement spending has been on the decrease to less than 21.5% in Fiscal Year 2008 (SBA).

Nonetheless, the European Commission, the leadership of the European Parliament, and other European authorities have been increasingly looking for ways to utilize the power of public procurement (representing approximately 16% of the European GDP) to harness its small business sector and to carry out broader socio-



economic objectives (EC, CORDIS, 2009; Manners, 2003; European People's; Matheson, 2008). Because governments in the United States and Europe (including individual European governments) are concerned with economic competitiveness and development, they recognize the unique economic and social contributions of small business as well as the unique challenges faced by small firms. In the context of public procurement, small businesses often become the focus of enterprise policy considerations (dealing with economic development and anti-monopolistic competition), industrial base policy considerations (assuring an economic foundation to achieve political objectives such as strong defense), or innovation policy objectives.

Over time, all public authorities are eventually confronted with the question of the proper role of small business in public procurement. Although the government as a buyer takes on many attributes of commercial firms, the activities of government in buying goods and services do not represent free-market activities. The government is spending public funds for public purposes. As a result, the taxpayers through their elected representatives (or, in the case of Europe, through national governments), may demand accountable decision-making in procurement and fair return in the form of work funded through government contracts. Often, the government is buying the “public goods” that the market would not otherwise supply in the same way, the same manner, or in the same quantities the government sets in response to public priorities.¹ Further, while and, in part, because the government

¹ For the industry, public goods are “instances in which marginal private net product falls short of marginal social net product, because incidental services are performed to third parties from whom it is technically difficult to exact payment” (Bell & Parchomovsky, 2005, pp. 531, 560, n. 159) (Abraham and Parchomovsky cite Arthur Cecil Pigou’s 2002 *The Economics of Welfare*, pages 183-84). Some commentators have argued that public procurement is a market for items which constitute or resemble pure public goods:

Government contracts frequently involve the construction of what economists call ‘public goods.’ “Public goods” are items—such as bridges, roads, and dams—which everyone is entitled to use whether or not they pay for the item. Thus, no market incentive exists to create such goods, because by definition even those who fail to pay for the good may benefit. As one author has noted: “Some goods and services cannot be provided through the price system because there is no way to exclude citizens from consuming the goods whether they pay for them or not. For example, there is no way to prevent citizens from benefiting from national expenditures on defense whether they pay money toward



buyer imposes significant regulatory compliance burdens and resembles a monopsonist,² the government procurement industry tends towards monopolistic or oligopolistic consolidation and concentration. These factors bring additional influences to bear on the private markets, with the potential to strongly encourage or strongly discourage economic activity by many private enterprises.³

defense or not. Consequently, the price system cannot be used to provide such goods; no one will pay for them since they will receive them whether they pay or not. [...] The Government provides many public goods. Such goods are consumed collectively, or jointly, and it is inefficient to try to price them in a market. They tend to be indivisible; thus they frequently cannot be split into pieces and be bought and sold in a market” (Mansfield, 1986). Thus, both theoretically and practically, government projects have no market value because the public has no incentive to purchase them (Perloff, 1993, pp. 185, 225, n. 302).

Others have argued that the means by which the government provides public goods involves both pure public-good-type items and commercial items that are bought in a different manner:

Government agencies purchase essentially two kinds of goods and services. The first consists of off-the-shelf commodities and services that are routinely bought and sold in ordinary commercial settings. The second is made of specialized products such as weapons systems. [...] Even for the off-the-shelf goods and services, however, government procurement statutes and regulations sometimes may result in a definition of a relatively narrow relevant market by restricting the range of firms that can compete for specific contracts. [...] Specialized goods and services usually present more difficult market definition/market power issues. For many nonstandard items, particularly military hardware, the government is virtually the sole purchaser. (Kovacic & Sims, 1990, pp. 32-33)

² “The government is not an ordinary purchaser, and it often is the only buyer (a monopsonist) for specialized equipment in question” (Kovacic & Sims, 1990, pp. 32-33). For instance, according to the US Government Accountability Office, the Department of Defense has actively encouraged and supported consolidation in the US defense industrial base:

The sharp decline in spending by DOD since 1985 has resulted in a dramatic consolidation of the defense industry, which is now more concentrated than at any time in more than half a century. [...] Since 1990, there has been a dramatic reduction in the number of prime contractors in 10 of the 12 markets DOD identified as important to national security. [...] This concentration was not unexpected. DOD has encouraged the defense industry to consolidate facilities and eliminate excess capacity to remain competitive and financially viable. (GAO, 1998)

The European defense market has a similar structure:

The economic characteristics of the defense sector are monopsony, the high costs of defense equipment, and the necessity to take life-cycle costs into account. [...] The defense sector is characterized as a monopsony. This means that the producers of hard-defense material often have only one prospective customer for their products: the government. Only their national government or, through exports, a foreign government will buy the equipment. (Trybus, 1999, p. 4)

³ When the government actively facilitates industrial base consolidation, its actions have tended to reduce competition, create significant financial risks for small firms at all tiers, and empower large suppliers to misuse market power by keeping out better innovations and solutions from small firms:



There are both numerous similarities and differences among the small business-specific procurement policies developed by the United States government and by the various levels of government in Europe. As shown below, these policies are rooted in the peculiar public procurement systems created on both sides of the Atlantic and in the specific economic, social, or other goals that public authorities hoped to accomplish. This paper will examine small business procurement policies across several key considerations, including the overall policy framework, definitions of small firms, creation of specialized institutions to assist small business with breaking into public procurements, access of small firms to suitable contracts, increasing transparency, promotion of economic and social sustainability, stimulation of innovation, and related considerations. While attempts will be made to make comparisons between policies that are representative of the US approach and one or more European approaches, this paper is not meant to provide a comprehensive review of small business procurement laws and regulations in every US government agency or in every European country. In addition, the role of political considerations in developing small business procurement policy is outside the scope of this paper.

The US Department of Defense actively encouraged and supported this defense industry consolidation and transformation in the United States in the 1990s, provided that a merger “produced efficiencies” and did not “significantly reduce competition.” In fact, the US government financially supported at least seven defense firm mergers between 1993 and 1997. [...] [G]iven the paucity of large platform procurements, for second-tier suppliers particularly, selection or non-selection as a participant in a major procurement project may be a “bet-the-company” proposition. [...] There is some conjecture as to whether the defense industry will continue to be dominated by a small number of “system integrator” defense contractors. One [prediction favors] the emergence of a new generation of “dozens” of “new and innovative” companies in the global defense industry, at least some of which will grow and mature into major industry players. [...] However, while small, niche players will undoubtedly continue to spring up and survive, the prediction that they will grow to become major industry players largely disregards the overwhelming bottom-line financial strength of the large systems integrators, making it perhaps more likely that large system integrators will acquire promising emergent defense companies or promising technologies rather than that the small, innovative companies will achieve a “critical mass.” [...] A particular risk that consolidation of the defense industry presents is that an entrenched supplier with a vested economic interest in a particular technology may use its financial or political influence to prevent adoption of a competing, superior technology developed by a small, innovative firm. (Marks & Fry, 2007)



II. Small Business Procurement Policy: General Framework

In order to understand the similarities and differences between the details of policies on small business contracting in the United States and in Europe, it is necessary to start by examining the fundamental principles that drive these policies. Once this is done, it becomes clear that fundamental small business contracting principles in the United States are, by and large, mutually reinforcing, while fundamental SME contracting principles in Europe are, by and large, in tension.

A. The US Approach: Maximum Practicable Opportunity to Ensure Fair Share

The US small business procurement policy is generally set in Section 1 and other provisions of the *Small Business Act of 1953*⁴ as binding law. This law emphasizes “full and free competition” as the “essence of the American economic system of private enterprise” (*USC*, 2010, Section 631a). The law notes that such unfettered competition is essential for achievement of pro-competitive economic goals such as “free markets” and “free entry into business” (*USC*, 2010, Section 631a). The Act also notes the social goals of increasing “opportunities for the expression and growth of personal initiative and individual judgment” and the defense policy goal of strengthening “the security of this Nation” through “preservation and expansion of such competition” (*USC*, 2010, Section 631a). The Act further directs the Federal government “to use all practical means and to take such actions as are necessary [...] [to] reduce the concentration of economic resources and expand competition” (*USC*, 2010, Title 15, Section 631a(a)).

⁴ Public Law No. 83-163, 67 Stat. 232 (July 30, 1953), *currently codified as amended in USC* Title 15 §§ 631-657o (2010). Section 1 of the *Small Business Act* is codified in Title 15, Section 631 of the *United States Code*.



To implement these goals, the Act embraces two related principles to govern the awards of Federal contracts and subcontracts. These policy principles emphasize the need for fairness to small contractors, both from the standpoint of acquisition planning, strategies, and process, as well as from the standpoint of measurable outcomes and results.

The first such principle is the principle of “maximum practicable opportunity” to participate in Federal contracts and subcontracts:

It is the policy of the United States that small business concerns, 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, shall 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. (*USC*, 2010, Title 15, Section 637d(1))⁵

The “maximum practicable opportunity” principle is generally implemented through process-type actions such as procurement strategies, subcontracting plans and award procedures, publicizing of procurement opportunities, providing small firms with information on procurement laws and regulations, breaking up large or complex contracts, and reserving or setting procurement opportunities aside for small firms.⁶

The second such principle is the principle of “fair proportion,” set forth as follows:

⁵ *Accord USC* Title 15 § 644(e)(1) (2010): “To the maximum extent practicable, procurement strategies used by the various agencies having contracting authority shall facilitate the maximum participation of small business concerns as prime contractors, subcontractors, and suppliers.”

⁶ *See, e.g.,* U.S. SMALL BUSINESS ADMINISTRATION, *SBA: Recognizing Best Practices in Increasing Opportunities for Small Businesses*, http://www.sba.gov/aboutsba/sbaprograms/goals/SBA_GOALING_BEST_PRACTICE.html (last visited Oct. 5, 2009).



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 (including but not limited to contracts or subcontracts for maintenance, repair, and construction) be placed with small-business enterprises, to insure that a fair proportion of the total sales of Government property be made to such enterprises, and to maintain and strengthen the overall economy of the Nation. (*USC*, 2010, Title 15, Section 631(a))

The “fair proportion” principles is generally implemented through planning measures such as contracting and subcontracting goals established by Congress, the President, Federal buying agencies, and the Small Business Administration, as well as through accountability reporting such as the annual Small Business Procurement Scorecard.⁷

In practice, these two principles and their implementing measures are often intertwined and conflated. As will be discussed below, this is a distinctively American approach, as the Europeans historically have sought to distinguish between measures assuring opportunity and measures assuring a certain participation share to their SMEs. Examples of such conflation in the United States include agency-specific fair share goals and set-asides of specific contracts or classes of contracts to achieve those goals (*USC*, 2010, Title 15, Section 644(a), (g)). For instance, in interpreting the so-called “Rule of Two” in the *Federal Acquisition Regulation (FAR)* which requires agencies to set aside any contract above \$100,000 unless there is no reasonable expectation of receiving fair-priced offers from two or more small businesses, the US Government Accountability Office (GAO) explained that “the Rule of Two is intended to implement the Small Business Act language in 15 U.S.C. sect. 644(a), quoted above, requiring that small businesses receive a ‘fair proportion of the total purchases and contracts for

⁷ See, e.g. U.S. SMALL BUSINESS ADMINISTRATION, *SBA Goaling Program*, <http://www.sba.gov/aboutsba/sbaprograms/goals/index.html> (last visited Oct. 5, 2009).



property and services for the Government' or support national defense" (Delex Systems, 2008). In procurements which were purportedly exempt from the *Small Business Act's* set-aside requirements by Executive Branch regulations, such as the Federal Supply Schedule task order competitions, small business size can nonetheless be used as a "significant evaluation factor" on an order-by-order basis (GSA et al., 2010, Section 8.405-5).

The *Small Business Act* was the initiative of President Dwight D. Eisenhower, who wanted to use the procurement system to maintain competition in the US economy.⁸ Soon after the passage of the *Small Business Act*, President Eisenhower

⁸ For two decades since 1932, the Herbert Hoover, Franklin Delano Roosevelt, and Harry S. Truman administrations have established limited-scope small business assistance agencies: the Reconstruction Finance Corporation (RFC), the Smaller War Plants Corporation (SWPC), the Office of Small Business (OSB) in the US Department of Commerce, and the Small Defense Plants Administration (SDPA), which focused mainly on financing and military procurement set-asides or other assistance. "To continue the important functions of the[se] earlier agencies, President Dwight Eisenhower proposed creation of a new small business agency -- the Small Business Administration (SBA)" with a comprehensive mandate to provide government-wide and economy-wide assistance to small firms (SBA). With creation of the SBA and the Cabinet Council on Small Business, President Eisenhower made small business procurement assistance a top policy priority for his administration:

The facts are plain on the record. They confirm the fact that this Administration has done more for small business than any prior administration [...]. First, we created the Small Business Administration, the first independent peace-time agency to devote itself exclusively to matters of interest to small business. This made a central focus for problems inherent in carrying on millions of small free-enterprise undertakings in America. Second, because these problems cut across the whole area of Federal activities, we established this year a Cabinet Committee on Small Business to be responsible on a continuing basis for developing policies and getting prompt action. Within this framework, we have taken positive steps to assist small business in these different ways: [...] (3) Government Procurement. During the last three fiscal years, Federal agencies directly awarded to small business concerns contracts totaling \$11.3 billion. This represents 22.2 percent of the total prime contracts awarded by the Federal Government during the period, considerably more than the 19.4 percent share awarded to small business during the fiscal years 1951-1953. Moreover, during the last three fiscal years small business received subcontracts amounting to additional billions. I was glad to know, for example, that over 400 small business firms are working on the construction at Shippingport, Pennsylvania, of the world's first large-scale atomic plant to make power exclusively for civilian use. (4) Government Set-Asides. This Administration has extended to other large Federal agencies--such as the Veterans' Administration, the General Services Administration, and the Interior, Agriculture, Commerce and Post Office Departments--the set-aside policy which had before applied only to the Department of Defense. Under this policy, certain governmental purchases are set aside for award exclusively to small business concerns. [...] (7) Management Counseling. To assist small business, the Small Business Administration and the Commerce Department collect expert information on management problems. Through publications, letters, and direct interviews by hundreds of field agents, they counsel with the owners of small businesses regarding management, procurement, new products,



created the Cabinet Committee on Small Business to spearhead the implementation of the Act and of small business-related activities throughout the Federal government. Writing to the Committee Chairman Arthur Burns, President Eisenhower observed:

[Small businesses] serve continuously as dynamic influence in our enterprise system. It is often through them that new products and new processes are first brought into use. Equally important, it is in small concerns that many men and women find an opportunity to demonstrate their ability to serve constructively in the business world. For these and related reasons, government policies that make it easier for these new businesses to be established and that foster the growth of small concerns enhance the welfare of the whole economy. (Eisenhower, 1956, June 1)

It must be noted that the US small business procurement policy is a Federal policy that exists within the Constitutional framework of separate state and Federal sovereignties.⁹ For this reason, in the United States, the states and the Federal government maintain separate public procurement systems. Therefore, the US procurement system at the national level does not, in general, regulate procurements by the states. One notable exception are small and minority business preferences in Federally-funded contracts awarded by States and local governments under President Ronald Reagan's *Executive Order 12432, Minority Business*

and financing. In particular, they help small firms get on government bidders' lists. Together with the procurement officers of all Federal Departments, the Small Business Administration organized 20 conferences in all parts of the country at the outset of the current major buying season. These meetings, which are attended by a very high percentage of small manufacturers in the nearby area, give full information on opportunities to do business with the Federal Government. I understand you personally attended the recent conference in nearby Syracuse on October ninth. Because this Administration is not content to rest on its record, progressive and sound as it is, we have been moving ahead with the recommendations for future action contained in the recent Progress Report of the Cabinet Committee on Small Business. One of these recommendations is the extension of the term of the Small Business Administration beyond the date of its present statutory expiration. Others are: [...] (2) Procurement--a comprehensive review of procurement policies, procedures and legislation, with a view to increasing small business' share in government contracts; steps to encourage greater sub-contracting to small business; and measures to insure that the need for progress payments by a small business concern will not handicap its obtaining a government contract. (Eisenhower, 1956, October 22)

⁹ See US CONST. amend. X.



Enterprise Development (Reagan, 1983). The most well-known of such preferences is the Disadvantaged Business Enterprise (DBE) program of the US Department of Transportation and the US Small Business Administration, which promotes participation by small minority-owned and women-owned firms in Federally-funded highway projects by requiring expenditure of at least 10% of highway funds for projects with such firms (USC, 2010, Title 49, Section 471113; DoT, SBA).

B. The European Approach: Tension Between Fair Access, SME Competitiveness, and Fair Return

In Europe, the small business policy, more accurately, small and medium enterprises (SME) policy, with regard to public procurement has been undertaken both by the European Union government bodies as well as by national and local governments. The European Commission restated its historic approach to small business procurement as follows:

Small and medium-sized enterprises are a unique source of innovation and competition in the internal market and account for 99.8% of the total number of EU enterprises. The European Commission has always paid particular attention to them. By facilitating their access to procurement opportunities, EU procurement policy allows those firms to strengthen their competitiveness and enables them to contribute more towards growth, employment, and competitiveness of the European economy. Commission action has mainly been focused on creating a level playing field where bids from firms, whatever their size or origin, have similar chances of success. Since the early 1990s, measures have been focused specifically on SME's needs in terms of simplification, information, services support, and promoting cooperation between SMEs on contracts. (2004, March)¹⁰

In 2000, the European Council set in motion a long-term reform of procurement and other policies throughout EU Member States by adopting *The European Charter for Small Enterprises* (European Council, 2000). The *European Charter* directed the EC and Member States to “pursue the reforms underway aiming

¹⁰ The European Commission (2004, March) report cites EC, 1992, June 1; 1990, May 7; 1998a, March 11.



at the completion in the Union of a true internal market, user-friendly for small business, in critical areas for development of small businesses including [...] public procurement” (European Council, 2000).

Historically, European efforts to promote small business procurements have been subject to a number of legal constraints. Arguably, these constraints stemmed primarily from various provisions of the Treaty Establishing the European Community (the EC Treaty), now called the Treaty on the Functioning of the Union,¹¹ and of the procurement directives adopted by the European Commission (EC, 2009, December 17). The EC Treaty “covers all public-sector procurement contracts with the European Community, no matter what their value. The Treaty sets down principles to prevent discrimination against firms from any member state” (UK Small, 2004, November). Contracts above various monetary thresholds established by the European Commission are regulated by the Commission’s procurement directives. Specifically, the Treaty-based constraints are known as the “four freedoms”:

Article 6 (prohibiting discrimination on grounds of nationality), Article 30 (free movement of goods), Article 48 (free movement of workers), and Articles 52 and 59 (freedom to provide services and the freedom of establishment). These provisions prohibit not only *direct* discrimination on the basis of nationality, but also treatment by a Member State which in *effect* discriminates against, or does not provide equal treatment to, a person or entity from another Member State. The importance of these provisions is that they provide a binding standard against which to consider *all* public procurement decisions by public contracting authorities. (McCrudden, 1998, pp. 219, 223).

For instance, in 1992 and 1993, the European Court of Justice invoked these “four freedoms” in two cases, *Commission of European Communities v. Italy* and

¹¹ “*The Reform Treaty* will contain two substantive clauses amending respectively the *Treaty on the European Union* (TEU) and the *Treaty establishing the European Community* (TEC). The TEU will keep its present name and the TEC will be called *Treaty on the Functioning of the Union*, the Union having a single legal personality. The word ‘Community’ will throughout be replaced by the word ‘Union’; it will be stated that the two Treaties constitute the Treaties on which the Union is founded and that the Union replaces and succeeds the Community” (EU, 2007, July 20, Annex I, Section I(2)). Because most literature cited here refers to the former “EC Treaty” name, that reference will be used.



Commission of European Communities v. Denmark, to invalidate national and local percentage-of-work, main-office-location, labor, materials, goods, and equipment preferences that effectively favored or could have favored local SMEs (McCrudden, 1998, pp. 223-224).¹²

European legal scholars disagree on whether these principles, as interpreted by the European Court of Justice and the European Commission, would extend to situations where preferences are available to SMEs without facial or as-applied discrimination on the basis of nationality. However, the weight of authority and logic appears to fall on the side favoring SME preferences as compatible with the EC Treaty. Professor Christopher McCrudden has argued in as early as 1998 that “[an] attractive possibility [in response to the *Commission of European Communities v. Italy* and *Commission of European Communities v. Denmark* decisions] is to open up preferences to the enterprises of other regions by providing that similar preferences apply to those enterprises which can demonstrate that they too fit within the social criteria laid down (so-called ‘communitarisation’). Such arrangements would need to ensure that contracts were open to all in fact as well as in form” (1998, p. 223). The legal viability of these arrangements under the EC Treaty “seems to depend on one’s conception of the principle of equality under the Treaty and the obligations that flow from it” (Hatzis, 2009, pp. 345, 349-350). According to the interpretation favored by Nicholas Hatzis, “[i]f the equality and non-discrimination obligations deriving from the Treaty have similar content with the corresponding obligations in the procurement directives” which he construed to prohibit “discrimination on the basis of nationality of any other ground,” than contracts subject only to the Treaty “may be subject to an onerous equality requirement which considerably restricts the discretion of contracting authorities and leaves no room for set-asides” (Hatzis, 2009). This interpretation of the Treaty rests chiefly on a ten

¹² McCrudden (1998) cites Case C-243/89, *Comm’n v. Italy*, 1992 E.C.R. I-3415, and Case C-360/89, *Comm’n v. Denmark*, 1993 E.C.R. I-3353.



year-old, self-contradictory European Commission communication which rejected SME prime contracting set-asides in favor of mandatory SME subcontracting and “good government” assistance such as publication of contracting opportunities (Hatzis, 2009, p. 347),¹³ and on two European Court of Justice decisions, *Parking Brixen v. Gemeinde Brixen*¹⁴ and *ANAV v. Comune di Bari*.¹⁵ The problem with this interpretation is the weakness of its supporting authorities. For example, the European Court of Justice decisions cited by Mr. Hatzis concerned government self-dealing in public procurements, i.e., situations where local government authorities have awarded contracts to entities they controlled. Self-dealing by local governments is inherently discriminatory of foreign suppliers, and, indeed, can induce private-sector bidding in reliance on a misleading appearance of an open competition. Of course, such design flaws are not intrinsic to EU-wide SME set-asides, so the cases can hardly be described as on point.

A contrary view advocated by commentators such as Andrew Erridge, Sue Arrowsmith, and Peter Kunzlik asserts that “it is wrong to read into the Treaty additional equality requirements which can only be derived from procurement directives. If this view is correct, then a policy of reserving contracts for SMEs could be lawful provided that it does not discriminate against SMEs from other member states” (Erridge, 1998).¹⁶ At the present time, it seems clear from European legal scholarship that the European Court of Justice has not foreclosed the possibility that SME preferences which are non-discriminatory on nationality grounds are perfectly consistent with the EC Treaty. Therefore, “if there is a change in policy by the Commission to allow certain contracts to be set aside for SMEs by including size of

¹³ Hatzis (2009) cites *Communication to the Council: Promoting SME Participation in Public Procurement in the Community* (EC, 1990, May 7).

¹⁴ Case C-458/03, 2005 ECR I-8612.

¹⁵ Case C-410/04, 2006 ECR I-3303.

¹⁶ “Set-asides are legal under European legislation for contracts below European thresholds. However, this use must not discriminate against SMEs from other Member States” (Erridge, 1998).



the company as criteria for excluding tenderers the directives could be amended without contradicting Treaty obligations, i.e., nondiscrimination on the grounds of nationality” (Erridge, 1998). As this paper demonstrates, the Commission and other European authorities have been modifying their SME policies to such an extent that the Commission communication on which Hatzis relied appears to no longer reflect current European policy.

The European Commission’s procurement directives further implement the Treaty by establishing “procedures and standards (based on openness, non-discrimination, and competition) for choosing tenderers and awarding contracts with an estimated value above a set limit” (Erridge, 1998). The EC Treaty and the European Commission directives have provided the overall framework for small business procurement policies of the Member states and their political subdivisions.

Over the last five years, European authorities attempted to minimize Treaty-based and policy-based constraints by issuing at least two legally binding Directives which expressly authorize and direct various forms of targeted procurement assistance to SMEs: Directive 2004/18/EC of March 31, 2004, *On the Coordination of Procedures for the Award of Public Works Contracts, Public Supply Contracts, and Public Service Contracts* (European Parliament, 2004, March 31). (a.k.a. the Public Procurement Directive or the “classic” procurement directive), and Directive 2009/81/EC of July 13, 2009, *On the Coordination of Procedures for the Award of Certain Works Contracts, Supply Contracts, and Service Contracts by Contracting Authorities or Entities in the Fields of Defense and Security, and Amending Directives 2004/17/EC and 2004/18/EC* (European Parliament, 2009, July 13). (a.k.a. the Defense Procurement Directive). EU Member States are required to achieve compliance with the Public Procurement Directive by January 31, 2006, and with the Defense Procurement Directive by August 21, 2011. Both Directives recognize that such assistance would be appropriate and desirable. In particular, the Defense Procurement Directive called on Member States to limit exclusions of defense items from European Commission directives and rules as authorized under



Article 296(1)(b) of the Treaty¹⁷ in the “context” of promoting the European Defense Technological and Industrial Base, including support for SME defense suppliers (European Parliament, 2009, July 13, Recital 3).¹⁸

The Public Procurement Directive “is based on [European] Court of Justice case law, in particular case law on award criteria, which clarified the possibilities for the contracting authorities to meet the needs of the public concerned, including in the environmental and/or social area, provided that such criteria are linked to the subject matter of the contract, do not confer an unrestricted freedom of choice on the contracting authority, are expressly mentioned, and comply with fundamental principles” of the Treaty Establishing the European Community such as free movement of goods, free establishment of business, equal treatment, non-discrimination, proportionality, and transparency (European Parliament, 2004, March 31, Recital 2). The classic directive recognized that social considerations, including SME participation, can be made part of the contracting process in two

¹⁷ As explained by Professor Martin Trybus:

Defense spending can be separated in two categories. The first is so-called “hard-defense material,” for example, battle tanks, fighter aeroplanes, and warships, which can be used for military purposes only. This is excluded from the EC Treaty by Article 296(1)(b) [...] The second category is the so-called “dual-use material” or “soft-defense material,” for example, cross-country vehicles, transport aircraft, and rescue ships, which can be used for military or civil purposes. This is covered by the EC Treaty and the directives, although some contracts for this material may fall within derogations from the Treaty and its directives which provide for protections of national security concerns, such as Articles 36, 38(3) and 56(1) [...] Civil goods purchased by the defense procurement authorities, for example, office equipment, are also covered. Thus the Community has jurisdiction over the market for dual-use material and civil goods but not over that for hard-defense material – a very weak position. (1999)

¹⁸ Directive 2009/81/EC cites *Interpretive Communication on the Application of the Article 296 of the Treaty in the Field of Defense Procurement* (EC, 2006, July 12) and *Communication from the European Commission to the European Parliament, the Council, the European Economic and Social Committee, and the Committee on the Regions, A Strategy for a Stronger and More Competitive European Defense Industry* (2007, May 12). Professor Christopher Yukins argues that the Defense Procurement Directive may limit national socioeconomic programs of various European Member States, but may also effectively create a socioeconomic preference in support of European defense firms and strengthen the defense industrial base exclusions of non-European firms from the common European defense market (2009, November 4, par. 383). This interpretation is supported by the *Commission Communication COM 2007(764) final, Strategy for a Stronger and More Competitive European Defense Industry* (EC, 2007, May 12) (calling for the need to reduce intra-EU barriers while improving the standing of the EU Defense and Technology Industrial Base as compared to the US industrial base).



circumstances. The first circumstance involves including social consideration as part of award criteria when awards are made on the “most economically advantageous tender,” or best value for money, basis (European Parliament, 2004, March 31, Recital 46). The second circumstance includes imposition of social contract performance conditions to which contractors must agree regardless of whether the award is made on the lowest price basis or the most economically advantageous tender/best value basis (European Parliament, 2004, March 31, Articles 23, 26).

The Defense Procurement Directive goes even further than the Public Procurement Directive in its support for SME procurement assistance by tying the support for SMEs to competitiveness and national security goals:

Member States agree on the need to foster, develop and sustain a European Defence Technological and Industrial Base that is capability driven, competent and competitive. In order to achieve this objective, Member States may use different tools, in conformity with Community law, aiming at a truly European defence equipment market and a level playing field at both European and global levels. They should also contribute to the in-depth development of the diversity of the European defense-related supplier base, in particular by supporting the involvement of small and medium-sized enterprises (SMEs) and non-traditional suppliers in the European Defence Technological and Industrial Base, fostering industrial cooperation and promoting efficient and responsive lower tier suppliers. . . The Commission should carry out a periodic assessment to examine whether the defense equipment market is functioning in an open, transparent and competitive way, including the impact of this Directive on the market, for example on involvement of SMEs. (European Parliament, 2009, July 13, Recitals 3, 79)

The European Commission (EC) echoes the same themes in its policies. On June 25, 2008, the European Commission issued Commission Communication COM (2008) 394, *Think Small First: A Small Business Act for Europe. The Small Business Act for Europe* is a set of ten principles to assist SMEs. One of these principles calls on European authorities to “[a]dapt public policy tools to SME needs; facilitate SMEs’ participation in public procurement and better use State Aid possibilities for SMEs” (EC, 2008a, June 25). As part of this effort, EC Commission



Staff published a voluntary *European Code of Best Practices Facilitating Access of SMEs to Public Procurement Contracts* (EC, 2008b, June 25). The *European Code* states that “increased involvement of SMEs into public purchasing will result in higher competition for public contracts, leading to better value for money for contracting authorities. In addition to this, more competitive and transparent public procurement practices will allow SMEs to unlock their growth and innovation potential with a positive impact on the European economy” (EC, 2008b, June 25). The *Code* lists solutions to assist small businesses with the following issues: “overcoming difficulties relating to the size of the contracts; ensuring access to relevant information; improving quality and understanding of the information provided; settling proportionate qualification levels and financial requirements; alleviating the administrative burden; putting more emphasis on value for money rather than price; giving sufficient time to draw up tenders; and ensuring payments on time” (EC, 2008b, June 25).

Similar policies or practices – some described in the *European Code* - have been adopted by EU Member State governments, EU agencies such as the European Defense Agency, and non-EU organizations such as the European Space Agency.¹⁹ For instance, in the United Kingdom, “[t]he Government’s policy on SMEs

¹⁹ See, e.g., Pieter Taal, Assistant Director, Industry and Market Directorate, European Defense Agency, Presentation, *Depth and Diversity of a Competitive EDTIB: SMEs in Defense* (January 13, 2010) http://ec.europa.eu/enterprise/sectors/defence/files/presentations/stockholm_conference/depht_and_diversity_of_a_competitive_edtib_en.pdf (describing SME procurement assistance measures including SME-focused research programs, assistance with low-value contracts, and subcontracting opportunity requirements); BAKER & MCKENZIE EUROPE, REMEDIES AND PUBLIC PROCUREMENT LAWS IN EUROPE, at 72 (3d ed. 2009) (citing Gesetz gegen Wettbewerbsbeschränkungen, the [German Act Against Restraints on Competition], 26 August 1998, BGBl. I at 2546, § 97(3) (F.R.G.), which requires consideration of SME interests in contracts meeting or exceeding EU thresholds through subdivision of contracts into trade and partial lots); Ioannis Petrou, *The European Space Agency’s Procurement System: A Critical Assessment*, 37 PUB. CONT. L. J., 141 (2008) (discussing ESA SME preferences); Martin Burgi, *Small and Medium-sized Enterprises and Procurement Law – European Legal Framework and German Experiences*, 4 PUB. PROC. L. REV. 284 (2007) (discussing SME-friendly and SME-favoring practices such as unbundling of contracts, grouping or teaming of small companies, mandatory SME subcontracting requirements, easier proof of suitability, division of contracts into lots, and limitations of lots per bidder); Ciara Kennedy-Loest, *Spreading Contract Work to Ensure Security of Supply and Maintain Competition: The Issues Under the EC Directives*, 2 PUB. PROC. L. REV. 116 (2007) (arguing that procurement measures favoring SMEs at contract size, teaming, qualification, award, and performance stages



is to encourage and support these organizations to compete for public sector contracts where this is consistent with the value for money policy of the U.K. regulations, EU Treaty principles, and EU procurement directives” (UK Office). In July 2009, the Irish Department of Enterprise, Trade, and Employment adopted a report on SME procurement assistance stating that “increased involvement of SMEs leads to better value for money” (Ireland, 2009, July). Procurement policies providing various supports for SMEs either directly or indirectly can be found both in long-term EU Member States, such as the United Kingdom, Germany, France, and Italy, and in new Member States from Central and Eastern Europe, such as Bulgaria or Estonia.²⁰

Indeed, support for SMEs appears inherent in procurements conducted by Europe-wide defense and space structures such as the European Defense Agency (EDA), its predecessor the Western European Armaments Group (WEAG), and the European Space Agency (ESA). Such support is driven by a comprehensive

are justified because they would carry out the objective of “opening up of public procurement to competition” as stated in the 2004/18/EC Public Procurement Directive); Andrew Erridge, *Involvement of SMEs in Public Procurement*, 2 PUB. PROC. L. REV. 37 (1998) (comparing early EU and British small business procurement initiatives with US initiatives).

²⁰ See, e.g. UK Public Contracts Regulations, 2006, S.I. 2006/5, Art. 7, ¶ 39, http://www.opsi.gov.uk/si/si2006/uksi_20060005_en.pdf (authorizing the use of social considerations as conditions for performance of contracts to the extent consistent with European Community law); Bulgaria Law for the Public Procurement, as amended, SG 56 1999, Arts. 6, 12, and 41 (June 9th, 1999) http://www.bcnl.org/doc_en.php?DID=316 (requiring consideration of SME subcontractor participation in awards of high-value prime contracts and authorizing the Council of Ministers to develop measures ensuring SME participation in low-level contracts.); Veiko Lember and Veiko Vaske, *Public Procurement in Post-Transitional Context: The Case of Estonia*, in INTERNATIONAL HANDBOOK OF PUBLIC PROCUREMENT, 409, 420 (Kvi Thai ed. 2009) (noting that low national thresholds and a procurement model that disfavors consolidated tenders can be deemed to favor SMEs); Laurance Folliot-Lalliot, *The Separation Between the Qualification Phase and the Award Phase in French Procurement Law*, 3 PUB. PROC. L. REV. 155, 158-159 (2009) (arguing that Articles 45, 50, and 51 of the French Public Procurement Code encourage SMEs to rely on qualifications of large businesses as part of bidder teams or groupings); Mario Comba, *Selection and Award Criteria in Italian Public Procurement Law*, 3 PUB. PROC. L. REV. 122, 124 (2009) (arguing that Italian administrative judges scrutinize contract qualifications requirements so as to protect SMEs from subjective biases of contracting authorities); Marcello Thompson Mello Guimaraes, *The Northern European Subset: An Open Platform for Cross-Border Procurement*, 4 PUB. PROC. L. REV. 175 (2008) (arguing that Denmark, Norway, Finland, Sweden, Norway, and Iceland created an e-procurement project, in part, to assist SMEs with cross-border procurements).



European industrial base development policy based on the principle of *juste retour* or “fair return” based on national investment in procurements, and its more recent formulation known as the principle of “mutual benefit” (Petrou, 2008; Georgopolous, 2006; 2005). The principle of fair return resembles national earmarking and “can be described as the equitable industrial return that states require for their domestic industries as a result of the states’ participation to a particular collaborative program. The principle is considered important for countries with small or medium sized defense industries because it secures the involvement of their domestic firms in the defense procurement market” (Georgopolous, 2006, p. 56). Its more recent formulation, the principle of mutual benefit “reflects the idea that in order for the establishment of a European Defense Equipment Market to be meaningful the participation of the largest possible majority of Member States is needed. In particular the aforementioned principle tries to bring on board those Member States which have small and medium-sized defense industries” (Georgopolous, 2005, p. 111). Arguably, the latter formulation targets SMEs from all EU countries, signifying a transition in defense industrial policy from the principle of *juste retour* towards support for SMEs (Georgopolous, 2005, p. 111; 2006, p. 57). In particular, at the European Defense Agency, its Steering Board on May 15, 2006 adopted the *Code of Best Practices in the Supply Chain* (COBPSC) in order “to ensure fair opportunities especially for small- and medium-size enterprises (SMEs)” and “to promote opportunities, where competition is efficient, practical, and economically or technologically appropriate on a level playing field basis for qualified and competent suppliers (both in-house and external), including SMEs” (EDA, 2006, May 15). This *Code* is enforced through Member States reciprocity. Another foundational EDA policy document, the *Strategy for the European Defense Technological and Industrial Base*, states:

We know that our vision of a healthy, competitive and integrated future EDTIB will not be realized if our market-opening efforts are perceived to be simply a bonanza for the large prime contractors. With industry’s active cooperation, we need to drive the benefits of competition down the supply chain – so that excellent second- and third-tier companies, often SMEs (with their typical



flexibility and capacity to innovate), are able to prosper in a European scale of market. This makes economic as well as political sense: the future success of the DTIB in Europe will depend upon effective utilization of human capital and innovation wherever these are to be found in Europe – in SMEs, and in suppliers not always associated with defense (universities, software houses, providers of dual-use technology), and in the new Member States. We note the slowness of Western European prime contractors to see the new Member States as places to invest, rather than just sell. (EDA, 2007, May 14)

At the European Space Agency, the policy of assisting SME contractors is even older. “During the March 1997 meeting of the ESA Council, Ministers of ESA Member States called upon the Director General of ESA to reserve a special place for small business. The objective is to guarantee them a share in the Agency’s technological activities, and to facilitate their access to technical facilities and tools” (ESA). Thus, European SME policies generally address both the issue of opportunity to compete and, to a lesser extent, the issue of share of participation in public procurement through reservation of certain procurement opportunities at the prime contracting and subcontracting levels for SMEs (ESA).

C. Comparison

Both the United States and Europe at the EU and Europe-wide agency level have well-established, comprehensive programs and policies on small business procurement assistance, and such policies are being rapidly implemented among the European Member States. However, the US policies and programs are older and better established than the European ones. While the US assistance measures for small contractors are focused on both the opportunity to participate (such as ensuring a transparent procurement process, providing advance notice of procurement opportunities, simplifying qualifications to bid, or reducing contract sizes) and the actual fair share of participation, the European assistance measures currently in place are focused more on the opportunity to participate. This, however, is changing as European assistance is becoming more focused on measurable,



identifiable participation outcomes such as the extent of participation of SMEs in specific contracts.²¹ Although Europe historically has not required or encouraged set-asides to the same extent as the United States, European policies and practices effectively include SME participation as an element of best value. In this way, the European approach is similar to the US significant evaluation factor approach in Federal Supply Schedule procurements. This approach creates uncertainty as to whether SME participation will, at the end, carry the day and drive the award of a specific contract. The European approach of requiring SME participation as a contract performance condition also introduces uncertainty, as such participation requirement can vary contract-by-contract. Both these approaches also convey the appearance of a procurement system free of SME preferences, when this is not the case. Nonetheless, assuming EU states will be following the EC Directives on public and defense procurement, it is likely that civilian and defense projects will be steered to European SMEs on an even greater scale.

²¹ See, e.g., *supra*, note 68; *accord* 2009/81/EC Defense Procurement Directive ¶¶ 20 and 21(4); 2004/18/EC Public Procurement Directive ¶32.



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III. Defining Small Business Enterprises

One clear and obvious indication of targeted policies to assist small businesses in government contracting is an official, legally binding definition of a small business for government procurement purposes. Both European and US authorities have adopted such definitions. These definitions include criteria that are specific to certain jurisdictions, contracts, or agencies, as well as criteria that are general and applicable to the procurement system at large.

A. The US Approach: An Industry-Sensitive Definition Framework

The United States traditionally has eschewed a one-size-fits-all approach to defining what would be a small business for purposes of government contracting. Instead, the United States has generally taken into account industry-specific trends and conditions. Industry trends and conditions may be reflected in varying measures of economic activities (e.g., employment or revenue), as well as in varying size caps (by revenue or numbers of employees) established for different industries or activities. This diversity makes eminent sense assuming the purpose behind small business definitions is to target relief and assistance to those companies most struggling to establish themselves and most vulnerable to anti-competitive pressures by large businesses or government officials. However, the objective of truly and accurately reflecting industry conditions is frequently in dynamic tension with the objective of avoiding red tape and legal uncertainty through clear and simplified rules. Congress, the Small Business Administration, and various tribunals and other agencies have been busy balancing these objectives for close to seven decades. In the Small Business Act, Congress provided that “a small business concern [...] shall be deemed to be one which is independently owned and operated and which is not dominant in the field of operation” (*USC*, 2010, Title 15, Section 632). Further, Congress gave the SBA the authority to specify, “in addition to the[ese] criteria, detailed definitions or standards by which a business concern may be determined to



be a small business concerns for the purposes [of the Small Business Act] or any other Act,” and generally prohibited Federal agencies from establishing their own small business definitions without SBA approval or separate statutory authority (*USC*, 2010, Title 15, Section 632). The SBA’s criteria “may utilize number of employees, dollar volume of business, net worth, a combination thereof, or other appropriate factors,” but the SBA “shall ensure that the size standard varies from industry to industry to the extent necessary to reflect differing characteristics of the various industries and consider other factors determined to be relevant by the [SBA] Administrator” (*USC*, 2010, Title 15, Section 632).²² The *Small Business Act* makes it “the duty” of the SBA “to determine within any industry the concerns, firms, persons, corporations, partnerships, cooperatives, or other business enterprises which are to be designated ‘small-business concerns’” and requires the SBA Administrator to issue upon request a revocable certificate that a concern is a small business (*USC*, 2010, Title 15, Section 637(b)(6)). Congress has generally refrained from establishing specific size standards by law (*USC*, 2010, Title 15, Section 632).²³ The SBA has promulgated Small Business Size Regulations pursuant to this authority in Title 13, Part 121 of the *Code of Federal Regulations*.

In the United States, size standards for government procurement purposes have changed over the years. According to the late US Senator Leverett Saltonstall, a member of Congressional leadership in the 1950s (Saltonstall, 1957, January 25), Congress originally passed a small business definition for defense procurement

²² Ralph Thomas (2009, February) gives a general description of the SBA’s size standards methodology:

Generally, the size status for manufacturing industries is employee-based in that a company’s size is determined by calculating the average employment of the company, including the employees of its domestic and foreign affiliates, based on the number of persons employed on a full-time, part-time, temporary, or other basis, during each of the pay periods of the preceding 12 months. For service and construction companies, the SBA, for the most part, uses a receipts-based standard whereby it determines size by averaging a firm’s annual receipts, including the receipts of its domestic and foreign affiliates (less returns and allowances, sales of fixed assets, and inter-affiliate transactions) for the previous three years.

²³ *Contra USC* Title 15 § 632 (2010) (setting forth a \$750,000 annual receipts cap for agricultural enterprises, including affiliates).



purposes in the *Selective Service Act of 1940*, imposing a size cap of “500 employees, including affiliated” (Saltonstall, 1957, January 25).²⁴ The *Selective Service Act of 1948* “defined a small business as one: (1) whose position in its trade or industry is not a dominant one; which does not have more than 500 employees; and (3) which is independently owned and operated,” provided that the employee count includes “its corporate and partnership affiliates” (Shestack & Long, 1950-1951).²⁵ Other Federal agencies apparently used other definitions for non-procurement purposes.²⁶ In 1957, the SBA extended the defense procurement definition with a 500-employee cap to civilian procurements (Saltonstall, 1957, January 25).²⁷ Congress, however, has frequently criticized the SBA’s 500-person size cap applicable to all Federal contracts as too inflexible and unresponsive to the realities of the marketplace (US House, 1993, May 25). The SBA decided instead to establish industry-specific size standards in reliance on the Standard Industrial Classification (SIC) of US industries by the Census Bureau. The SIC system assigned codes to industries pursuing different economic activities, and SBA periodically revised its SIC-based standards (US House, 1993, May 25).

²⁴ Saltonstall apparently refers to the industrial mobilization provisions in Section 9 of the *Selective Training and Service Act* of September 16, 1940, ch. 720, 54 Stat. 885, formerly codified as 50 USC App. § 309 (1946).

²⁵ Shestack and Long cite Act of June 24th, 1948, Pub. L. No. 80-759, § 18(a). Section 18(a) of the Selective Service Act of 1948 was concerned with inequitable rationing of defense contracts as well as raw materials or other supplies for use in their production to large firms, and so stated that “[u]nder any such program of national procurement, the President shall recognize the valid claim of American small business to participate in such contracts, in such manufactures, and in such distribution of materials, and small business shall be granted a fair share of the orders placed, exclusively for the use of armed forces of for other Federal agencies [such as the Atomic Energy Commission] now or hereafter designated in this section.” Comment, *Utilization of Industry Section of the Selective Service Act of 1948*, in *Statutes*, 24 N.Y. U. L. Q. REV. 211, 216, n. 1 (1949).

²⁶ For instance, by the end of 1950s, the Bureau of Census established its own definition, with the size cap measured to be less than 100 employees for manufacturing firms and the size of “distributing firms” measured based on the sales volume, while firms with less than \$250,000 in assets were considered small for tax purposes (Saltonstall, 1957, January 25).

²⁷ *accord Otis Steel Products Corp. v. United States*, 316 F.2d 937 (Ct. Cl. 1963) (citing 13 C.F.R. § 103 (1958 Supp.) which provided: “*Determination of small business for Government procurement. — (a) General definition.* A small business concern for the purpose of Government procurement is a concern that (1) is not dominant in its field of operation and, with its affiliates, employs fewer than 500 employees, or (2) is certified as a small business concern by SBA.”).



Since 1997, the SBA has abandoned the SIC system and instead has relied on the North American Industrial Classification System (NAICS) to determine the type of industry in which a company is participating. NAICS was developed to facilitate better comparisons among industries of the United States, Canada, and Mexico. According to the SBA's *Guide to Size Standards*, the SBA "has established two widely used size standards – 500 employees for most manufacturing and mining industries and \$7.0 million in average annual receipts for most nonmanufacturing industries. However, many exceptions exist" (SBA). Size standards generally apply to procurement as well as non-procurement assistance. Common industry-specific size standards include: size standards ranging from \$7 million to \$20 million in average annual receipts for various industries related to construction and dredging; size standards capped at 750, 1,000, or 1,500 employees for certain manufacturing industries not subject to the 500 employee size standard; a 500 employee size standard for non-service mining industries; size standards ranging from \$7 million to \$29 million in average annual receipts for retail industries; size standards ranging from \$7 million to \$35.5 million in average annual receipts for most service industries; a 500 employee plus size standard for wholesale trade industries along with a generally applicable requirement that items supplied be a product of a US small business manufacturer (SBA). Other industries such as finance, insurance, transportation, or electricity, have size standards with "no common pattern" for industry groups. In addition, a few industries have additional regulatory conditions for purposes of government procurement programs, such as the 125,000 barrels per calendar day total operable atmospheric crude oil distillation capacity for petroleum refineries (SBA). For purposes of pro-innovation set-aside competitions under the Small Business Innovation Research Program and the Small Business Technology Transfer Program, the size standard is 500 employees regardless of the industry in which the R&D work is to be conducted (*CFR*, 2010, Title 13, Section 121.702). For purposes of the Very Small Business (VSB) Set-Aside Pilot Program in existence



between 1994 and 2003, the size standard was 15 employees or less and average annual revenues of \$1 million or less.²⁸ Detailed size standards are published in the SBA's regulations and its *Table of Size Standards*, and they have the force and effect of law (*CFR*, 2010, Title 13, Section 121.201; GSA et al., 2010, Section 19.102). To accommodate the diversity of industries and programs, size standards have become rather complex: the *Table* goes on for 44 pages setting forth size standards in well over 1000 industry categories, while the *Guide* goes on for another 17 pages.

A business concern may be small in one industry category and yet large in another. Under SBA regulations, contracting officers are responsible for choosing the NAICS code which best describes the “principal purpose” of the product or service acquired (*CFR*, 2010, Title 13, Section 121.402(b); GSA et al., 2010, Section 19.102). The basis for this decision is subject to a complex six-factor test, which includes: (1) “industry descriptions” in the NAICS Manual, (2) description of product or service in solicitation documents, (3) “value and importance” of the procurement’s components, (4) functions of products and services procured, (5) prior procurement classifications in similar purchases, and (6) the purposes of the *Small Business Act* (*CFR*, 2010, Title 13, Section 121.402(b); GSA et al., 2010, Section 19.102). A procurement is usually classified according to the component which accounts for the greatest percentage of contract value. Despite their complexity, the US small business size definitions are publicly available and generally applicable to contracts and subcontracts across Federal agencies.

SBA’s employee-based caps are calculated prior to each representation or certification of small business size based on the average number of employees for each pay period “over the preceding 12 months” (*CFR*, 2010, Title 13, Section 121.106; GSA et al., 2010, Section 19.101). Part-time or temporary employees

²⁸ FAR (GSA et al., 2003) Subpart 19.9, § 52.219-5 provides for set-asides of small contracts for very small businesses within certain geographic areas.



count the same as full-time employees (*CFR*, 2010, Title 13, Section 121.106; GSA et al., 2010, Section 19.101). Total average employees of all entities considered affiliated with the enterprise which have been employed by those affiliates over the preceding 12-month period (even if affiliation arose more recently) are included in the count (*CFR*, 2010, Title 13, Section 121.106; GSA et al., 2010, Section 19.101). There is no official definition of a “medium-sized business” in the United States for procurement purposes.²⁹

In addition to assuring predictability and transparency in small business definitions, Congress and the SBA have established a panoply of safeguards to protect the US small business size definitions from fraud and manipulation. These safeguards include not only publicly available and legally binding definitions, but also the process to appeal the NAICS designations for individual contracts (*CFR*, 2010, Title 13, Section 121.1101, 1102); the process to protest to the SBA a company’s representation that it is a small business (*CFR*, 2010, Title 13, Section 121.1001-1101); the regulations concerning affiliation with large businesses and ostensible subcontracting with large businesses (*CFR*, 2010, Title 13, Section 121.103;³⁰ regulations concerning recertification of former small business which became large

²⁹ *Cf.* *CFR* § 296.2) (2010) (providing that criteria for a medium-sized business definition in the US Department of Commerce Technology Innovation Program will be determined by reference to the total revenues of the 1000th company on the Fortune 1000 list).

³⁰ The “ostensible subcontractor rule” was recently described by the SBA Office of Hearings and Appeals (2006, October 17) as follows:

The ostensible subcontractor rule is an independent basis for finding affiliation between two concerns. 13 C.F.R. § 121.103(h)(4). The purpose of the rule is to prevent other than small firms from forming relationships with small firms to evade SBA's size requirements. The ostensible subcontractor rule permits the Area Office to determine a subcontractor and a prime have formed a joint venture (and are thus affiliates) for determining size. An ostensible subcontractor is a subcontractor that performs primary and vital requirements of a contract or a subcontractor upon which the prime contractor is unusually reliant. 13 C.F.R. § 121.103(h)(4). In determining whether a subcontractor performs primary and vital requirements or that the prime is unusually reliant, the Area Office must consider all aspects of the prime-subcontractor relationship including, but not limited to, the terms of the proposal, agreements between the prime and the subcontractor (such as teaming agreements), and whether the subcontractor is an incumbent contractor and is ineligible to submit a proposal because it exceeds the size requirements for the solicitation.



through growth, mergers, or acquisitions;³¹ prohibition on subcontracting the majority of the work on small business set-asides to large businesses, known as “limitations on subcontracting” (*USC*, 2010, Title 15, Section 644(o); GSA et al., 2010, Section 52.219-14); and criminal and civil penalties for misrepresentation of small business size (*USC*, 2010, Title 15, Section 645(d)). Individual Federal agencies generally cannot, on their own, adjust small business size or status requirements or safeguards such as the limitation on subcontracting for individual contracts.³²

Perhaps the most important policy safeguards against manipulation of small business definitions in the US procurement system are the SBA’s rules limiting affiliation of small business concerns with other businesses. In particular, the SBA affiliation regulations in Title 13, Section 121.103 of the *Code of Federal Regulations* provide that “concerns and entities are affiliates of the other when one controls or has the power to control the other, or a third party or parties controls or has the power to control both. It does not matter whether control is exercised, as long as the power to control exists” (*CFR*, 2010, Title 13, Section 121.103). Affiliation is determined based on totality-of-the-circumstances basis, relevant factors include not only ownership, but also management, prior relationships, indirect ties through third parties, and contractual relationships (*CFR*, 2010, Title 13, Section 121.103). Affiliation may be found based on negative control, which includes “instances where a minority shareholder has the ability, under the concern’s charter, bylaws, or shareholders’ agreement, to prevent a quorum or otherwise block action by the board of directors or shareholders” (*CFR*, 2010, Title 13, Section 121.103). Affiliation may be found even where no single factor by itself would create affiliation (*CFR*, 2010, Title 13, Section 121.103). Thus, affiliation restrictions are drawn to be intentionally broad in order to serve as catch-all for schemes to manipulate small business programs.

³¹ See 71 Fed. Reg. 66434-66444 (Nov. 15, 2006).

³² See, e.g. *Centech Group v. United States*, 554 F.3d 1029 (Fed. Cir. 2009).



SBA affiliation regulations (*CFR*, 2010, Title 13, Section 121.103) illustrate seven categories of affiliation. The first category is affiliation based on stock ownership. Control here is found where a person or entity “owns, or has the power to control, 50 percent or more of a concern's voting stock, or a block of voting stock which is large compared to other outstanding blocks of voting stock,” and rebuttable presumption of control is created where two or more persons or entities who are holding minority voting stakes “and such minority holdings are equal or approximately equal in size, and the aggregate of these minority holdings is large as compared with any other stock holding” (*CFR*, 2010, Title 13, Section 121.103). Where the “voting stock is widely held and no single block of stock is large as compared with all other stock holdings, the concern's Board of Directors and CEO or President will be deemed to have the power to control the concern in the absence of evidence to the contrary” (*CFR*, 2010, Title 13, Section 121.103). The second category is affiliation arising under stock options, convertible securities, and merger agreements. In these circumstances, affiliation is determined based on the “present effect of the power to control the concern” even if the power has not yet been exercised (*CFR*, 2010, Title 13, Section 121.103). The third category is affiliation based on common management, which arises in cases of interlocking officers, directors, partners, or other management (*CFR*, 2010, Title 13, Section 121.103). The fourth category is affiliation based on identity of interest. In these circumstances, regulations create a rebuttable presumption of affiliation where persons or firms have the same or “substantially identical” business lines, common investments, or mutual economic dependencies through contractual or other relationships (*CFR*, 2010, Title 13, Section 121.103). The fifth category is affiliation based on involvement of key employees of one concern in another, newly organized concern. The SBA regulations create a rebuttable presumption of affiliation where there are interlocking key employees, shareholders, or managers, both concerns are in related industries, and one concern is providing substantial financial or technical assistance to another (*CFR*, 2010, Title 13, Section 121.103). The sixth category is affiliation based on joint ventures and ostensible subcontracting. Joint ventures are



associations of persons or companies that pool together their resources for specific business undertakings, and make no more than 3 proposals over a 2-year period. Joint venturers are generally considered affiliated, unless they are subject to exceptions such as mentor-protégé arrangements between small and large firms, small disadvantaged firms admitted in the Section 8(a) Business Development program and large firms, or unless the joint venture is bidding or proposing on a contract that is so large or complex that it is considered “bundled” under SBA regulations (*CFR*, 2010, Title 13, Section 121.103). This category also includes a rule treating a prime contractor and an ostensible subcontractor joint venturers and affiliates if a prime contractor is unusually reliant on an ostensible subcontractor, if that subcontractor performs primary and vital functions of the contract, or if the contract was a set-aside and that subcontractor was previously an incumbent and was ineligible to bid or propose for the set-aside (*CFR*, 2010, Title 13, Section 121.103). The final, seventh category is affiliation based on franchise and license agreements. Any such agreements which give the franchisor profit rights and loss risks incident to ownership would result in affiliation (*CFR*, 2010, Title 13, Section 121.103).

The SBA affiliation regulations also provide seven exceptions from affiliation. These exceptions include business concerns owned wholly or partially by the SBA-regulated Small Business Investment Companies; business concerns owned and controlled by Indian tribes, Alaska Native Corporations, Native Hawaiian Organizations, or Federally-assisted Community Development Corporations; business concerns which participate in SBA-approved R&D pools; business concerns which lease employees or which obtain employees from Professional Employer Organizations (PEOs); for certain types of assistance, business concerns with outside investors that are venture capital operating companies, employee benefit or pension plans, charitable trusts and foundations, and certain types of investment companies; mentor large businesses under Federal Mentor-Protégé programs for small contractors; and small agricultural cooperatives (*CFR*, 2010, Title



13, Section 121.103). Under recent amendments to SBA regulations related to the Small Business Innovation Research Program and small business procurement programs, venture capital ownership of 49% or less would not, by itself, create affiliation (SBA, 2007, October 18). Moreover, business concerns majority-owned by venture capital companies which themselves are owned and controlled by individual US citizens or permanent residents may still be considered small as long as all affiliates have less than 500 employees (SBA, 2007, October 18). All these exceptions are rather straightforward. In contrast, the affiliation restrictions are subject to greater SBA discretion.

B. The European Approach: A User-Friendly Definition Framework

European nations have had a variety of SME size standards or definitions. However, within the EU framework, the European Commission is responsible for promulgating a definition applicable to EU activities. The Commission's definitions of SMEs are not legally binding on Member States (EC Directorate). Prior to 1996, the EU SME definition corresponded to the traditional US size standard cap of 500 employees (Storey, 2003, p. 477). However, since 1996, the Commission has adopted two recommendations concerning SME definitions: Commission Recommendation 96/280/EC of April 3, 1996, and Commission Recommendation 2003/361/EC of May 6, 2003, which became effective on January 1, 2005 (EC Directorate).³³ The latest definition applies to EU agencies and programs, such as the European Defense Agency, and EU Members States are invited to use it (EC Directorate; EDA). ESA also follows this definition (ESA). The EU definitions are also used in the EEA area, for example, in Switzerland (Swiss Confederation, 2009, May).

³³ *The New SME Definition: User Guide and Model Declaration* (EC Directorate, ?) cites *Commission Recommendation 96/280/EC Concerning the Definition of Small and Medium-Sized Enterprises*, O.J. (L 107) 4-9 (April 30, 1996), and *Commission Recommendation 2003/361/EC Concerning Micro, Small, and Medium-Sized Enterprises*, O.J. (L 124/36) 36-41 (May 20, 2003)).



The 2003 EC Recommendation establishes “staff headcounts and financial ceilings determining [three] enterprise categories”: SMEs (or “micro, small, and medium-sized enterprises”), small enterprises, and microenterprises. SMEs are “made up of enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million.” Small enterprises are those that employ less than 50 persons, with an annual turnover and/or balance sheet not exceeding EUR 10 million. Microenterprises are those that employ less than 10 people, with an annual turnover and/or balance sheet total not exceeding EUR 2 million. According to the European Central Bank’s 2009 data, this represents dollar-based ceilings worth approximately \$71 million in annual turnover and/or an annual balance sheet worth approximately \$61 million for SMEs, of \$14 million for small enterprises, and of \$3 million for microenterprises (ECB).³⁴ According to the *New SME Definition User Guide*, “annual turnover is determined by calculating the income that your enterprise received during the year in question for sales and services after all rebates have been paid out,” not including value-added and other indirect taxes, while “the annual balance sheet refers to the value of your company’s assets” (EC Directorate). Employees are calculated in “annual work units” (AWUs), a concept that parallels the American concept of full-time equivalents (FTEs.) As a result, part-time and seasonal workers are included in the calculation as parts of AWUs. However, time spent on paternity or maternity leave is not counted. Employees, active partners, managing owners, and employees “of subordinate enterprises” who are considered employees under national laws of EU Member States are also included in the AWU calculation. On the other hand, apprentices or vocational training students are not included in the count (EC Directorate).

It is important to note that not all EU Member States follow the EC definition. For instance, the UK, a country with a large and well-established procurement

³⁴ Establishing a rate of \$1.4268 per 1 Euro.



system, currently appears to target its procurement assistance “for small and medium-sized enterprises (SMEs), with up to 500 employees” (UK Office).

The 2003 EU definition contains several protections against manipulation and circumvention by large businesses. However, in comparison with the 1996 EU definition, these protections have been relaxed in order to enable companies to attract outside financing.³⁵ Anti-manipulation and anti-circumvention measures under the 2003 definition include rules governing affiliation with SMEs of other business entities, natural persons, universities, venture capitalists and business angels, and even government authorities. The affiliation rules draw a distinction between three types of SMEs: autonomous, partner, and linked enterprises. Employees and financials from linked and partner enterprises are added to the count of the company declaring itself an SME to determine whether that company is, in fact, an SME. Generally, an enterprise is considered autonomous if it: “does not have a holding of 25 percent or more in any other enterprise; is not 25% or more owned by any enterprise or public body or jointly by several linked enterprises or public bodies . . . and does not draw up consolidated accounts and is not included in the accounts of an enterprise which draws up consolidated accounts and is thus not a linked enterprise” (EC, 2003, May 6, Section 1). For example, an enterprise where the owner accepted three investors at 20% each would be considered autonomous if these investors are not linked to each other.³⁶ A partner enterprise “represents the situation of enterprises which establish major financial relationships with other enterprises, without the one exercising direct or indirect control over the other,” i.e. where an enterprise “has a holding or voting rights equal to or greater than 25% in the other enterprise” or the holdings are reversed, and the enterprises are not considered linked through consolidated accounts or voting rights in excess of 50%

³⁵ Compare *Commission Recommendation Concerning the Definition of Small and Medium-Sized Enterprises* (EC, 1996, April 3) with *Commission Recommendation Concerning Micro, Small, and Medium-Sized Enterprises* (EC, 2003, May 6).

³⁶ Cf. *EC New SME Definition Guide* (EC Directorate).



(EC Directorate). Finally, enterprises are considered linked if “enterprises form a group through the direct or indirect control of the majority of the voting rights (including through agreements, or in certain cases, through natural persons acting as shareholders) or through the ability to exercise a dominant influence on an enterprise” (EC Directorate). A partner enterprise must include the percentages of employees or financials of upstream and downstream partner enterprises (together with any upstream or downstream enterprises with which they are linked) in proportion to the percentage of the holdings. Data from partners of partner enterprises one step removed is not included. On the other hand, linked enterprises must include all employees and financials of all linked upstream or downstream enterprises, as well as data from their partners.

However, the 2003 EU definition contains a number of exceptions. Public investment corporations, venture capital companies, business angels investing up to EUR 1.25 million, universities, non-profit research centers, institutional investors, including mutual funds and regional development funds, and autonomous local authorities with annual budget of below EUR 10 million and less than 5,000 inhabitants, may all each invest up to 50% into an enterprise without the enterprise losing its autonomous SME status. These investors are prohibited from being involved in management, but may otherwise exercise shareholder rights. In such circumstances, the 2003 EC definition provides for a presumption that dominance does not exist. Unless there is linking between investors’ enterprises or linking through natural persons that involved operations in the markets that are the same, directly upstream, or directly downstream, there would be no linking of the SME with investors under the 2003 EC definition.

Separately, the European SME Code encourages SMEs to invoke Article 47(2) of the Public Procurement Directive, which authorizes contractors “where appropriate and for a particular contract, [to] rely on the capacities of other entities, regardless of the legal nature of the links it has with them.” This policy could be



viewed as authorizing ostensible subcontractor-type arrangements with large businesses.

Further, the apparent clarity and predictability of the EU definition is obviated by the absence of mandatory size enforcement process and by the language granting safe harbor to companies declaring themselves SMEs “even if the capital is spread in such a way that it is not possible to determine by whom it is held” (EC, 2003, May 20). The European Commission permits such a company to “declare in good faith that it can legitimately presume that it is not owned as to 25% or more by one enterprise or jointly by enterprises linked to another” (EC, 2003, May 20). Such declarations, however, may be challenged in the course of “check and investigations” under separate EU or Member State laws or rules (EC, 2003, May 20).

C. Comparison

In terms of public policy objectives, Europe appears to emphasize user-friendliness, clarity, simplicity in its SME definitions. This is particularly true with regards to concerns related to affiliation with other entities: a European contracting official or SME owner could, by consulting *The New SME Definition Guide*, easily determine whether or not an enterprise in question is a large business by affiliation. This is a substantial advantage in the administration of small business assistance measures. However, it would be hard to argue that this one-size-fits-all approach is a genuine reflection of conditions in the industries in which small firms have to compete. Accordingly, SME-specific assistance in Europe could simultaneously be denied to deserving firms in some industries and extended to firms which would be considered large under an industry-specific analysis in other industries. On the other hand, the complexity of the US small business size standards is somewhat of a necessary evil because it reflects considerations of industry-specific conditions and fair competition among similarly situated firms in the same industries.



In terms of the absolute measures of size, the competitive impact of assistance based on these definitions is hard to estimate across the board. For example, the UK apparently still uses the 500-employee definition in some circumstances, equivalent to the traditional American standard. The EU has the larger size caps across all industries in general, while America has the larger overall size caps in some of its industries. Thus, while competitive impact will be determined on an industry-by-industry basis, US services firms would be generally disadvantaged by the EU SME definition while US manufacturers should be favored by it. Moreover, the European definition favors jobs-creation more than the US definition. This is because the underlying mathematics used in calculating employee-based size caps is not same across the Atlantic. One AWU/FTE-based European employee can equal several US employees based on counting rules in the SBA regulations. As a result, an US R&D or manufacturer firm with 100 full-time employees and another 600 employees working only a quarter of an FTE each would be the economic equivalent of a European enterprise employing 250 AWU employees. As a matter of SBA regulations, such US firm would bust even the supposedly higher 500-employee US size standards for R&D or manufacturers by 200 employees, would be branded a large business, and would be denied procurement assistance or preferences under the Small Business Act. The US firm appears to be a giant almost 3 times larger than the European firm, but this appearance is false. In reality, the two firms have the same size as measured by full-time employment. Had such US firm relocated to Europe, it would still have qualified for SME-specific procurement measures. By using the AWU/FTE method, Europeans enable their SMEs to create more jobs than US firms before the European SMEs are forced to compete as large businesses.

The supposed advantages for US small businesses in industries with relatively high size standards lose their luster even more once the US and the EU definitions are compared for protections against manipulation and fraud are considered. In comparison with the US small business size standard system, the



European definition does not sufficiently protect independence of ownership or operation of SMEs, and is highly vulnerable to fraud and manipulation by large businesses or investor government agencies. First, the European affiliation and anti-circumvention rules plainly allow companies that are majority-owned by large businesses and government agencies to qualify as autonomous SMEs as long as each such investor owned less than 25%. Indeed, based on examples throughout *The New SME Definition Guide*, an SME would be considered merely partnered if a large business owned just under 50% and two other large businesses owned between 20% and 25% each. Second, negative control affiliation is not recognized under the EU definition; instead, the EU definition contains what appears to be a legal presumption that minority shareholders do not control an SME. These policies further tilt the competitive field towards Europe over the United States by opening the doors to large business manipulation of European SME procurement assistance measures. Third, the European affiliation rules for partner enterprises exclude the majority of their employees from the count of the enterprise claiming SME status. The integrity of the definition is stronger in the United States, where SBA affiliation rules require adding all employees of all affiliated firms. Fourth, the EC imposed no requirements that an SME perform the majority of the work on a public contract or subcontract, or provide supplies manufactured by an SME. In addition, the EC does not require a formal size protest mechanism, companies may declare their SME status claiming “in good faith” lack of knowledge of their own ownership, and the 2003 EC Recommendation says nothing about whether the European authorities would aggressively pursue criminal or civil fraud enforcement of SME size fraud.

Thus, from the US perspective, there is a real risk that European programs for SMEs, such as R&D set-asides, will operate as mere domestic preferences for European firms regardless of size.



IV. Creation of Small Business Procurement Assistance Agencies

To assist small firms with accessing public procurement markets, both European and US authorities created specialized government institutions. These institutions not only provide financing and technical assistance counseling to the private sector, but they also engage their sister agencies in efforts to expand procurement opportunities to small firms. However, these institutions appear to be more independent in the United States.

A. The US Approach: An Independent, Central Small Business Advocate and Regulator

Beginning with the World War II era, the US government intensified its efforts to assist small firms with tapping the federal procurement market. As part of this effort, the government legislated several times the establishment of a special agency to assist small firms with government contracts and related financial and technical development assistance: the Reconstruction Finance Corporation (1932), which was created by President Herbert Hoover as a financing agency and acquired contracting responsibilities following World War II; the Smaller War Plants Corporation (1942), which was created by Congress with the passage of the *Small Business Mobilization Act*³⁷ (US Congress, 1942, June 11); the Small Defense Plants Administration (1952); and, finally, the Small Business Administration (SBA) (1953) (Saltonstall, 1957, January 25).³⁸ An independent Federal agency with Presidentially-appointed, Senate-confirmed Administrator and Deputy Administrator, the SBA “shall be under the general direction and supervision of the President and shall not be affiliated with or be within any other agency or department of the Federal Government” (*USC*,

³⁷ Formerly codified at 50A *USC* §§1101-1109.

³⁸ *Accord SBA Overview and History*.



2010, Section 633(a)). To further enhance the SBA's independent voice with regards to complaints of small businesses, regulatory relief, and studies of small business programs (including government contracting programs), Congress created within the SBA a special Office of Advocacy lead by the Presidentially-appointed, Senate confirmed Chief Counsel for Advocacy (*USC*, 2010, Section 634a-634g). Indeed, President Eisenhower, the father of the SBA, observed that the agency had to work "[j]ointly with the Department of Defense and with other Federal departments and agencies" as it "assist[ed] small concerns in obtaining government procurement contracts" (Eisenhower, 1956, June 1). Nonetheless, the SBA has been endowed with powers not only to engage in cooperative intergovernmental efforts (*USC*, 2010, Section 631a(a)), but also to promulgate regulations binding on private individuals and other agencies (*USC*, 2010, Section 634). The SBA has issued numerous regulations concerning small business contracting and subcontracting, generally found in Title 13, Chapters 101, 115, 121, 124, 125, 126, and 127 of the *Code of Federal Regulations*.

In addition, the SBA has been directed by the *Small Business Act* (*USC*, 2010, Section 644) to designate Procurement Center Representatives (PCRs) (as well as Breakout Procurement Center Representatives (BPCRs), and other personnel) for oversight of major buying activities of the government, including:

reviewing proposed acquisitions and recommending alternative procurement strategies; identifying qualified small business sources; reviewing subcontracting plans; conducting reviews of the contracting office to ensure compliance with small business policies; counseling small businesses; and sponsoring and participating in conferences and training designed to increase small business opportunities. (Executive Office et al., 2002, October 29)

To emphasize the importance of advocacy for small business within government agencies, the *Small Business Act* also directed that each Federal agency with contracting authority must establish the Office of Small and Disadvantaged Business Utilization (OSDBU), with the director reporting to the head



of the agency (Executive Office et al., 2002, October 29). OSDBUs are “responsible for ensuring that small businesses have the maximum practicable opportunity to participate in the performance of federal contracts as both prime contractors and subcontractors” (Executive Office et al., 2002, October 29). OSDBU offices are required by law to closely work with the SBA (*USC*, 2010, Section 634). OSDBUs coordinate their efforts through participation in a voluntary Federal OSDBU Director Interagency Council and in the formal Federal Small Business Procurement Advisory Council, chaired by the SBA Deputy Administrator (US Congress, 1994; Denett, 2008, March 6). OSDBUs in Federal agencies are responsible for implementing not only the *Small Business Act* but also agency-specific small business procurement statutes, such as the space- and defense-related small business goaling, set-aside, preference, and incentive authorities in Title 10, Sections 2323 and 2323a of the *United States Code*. Such agency-specific authorities generally enhance the policies of the *Small Business Act*.

Finally, small business procurement initiatives are promoted and supported through the White House Office of Federal Procurement Policy (OFPP). The OFPP is charged by its authorizing statute with developing policies that would help Federal agencies achieve their small business goals and would ensure “maximum practicable opportunities” for small business participation in small-dollar procurements (*USC*, 2010, Title 41, Section 405).³⁹ The OFPP is also required to promulgate uniform procurement regulations for the Federal government (known as the *Federal Acquisition Regulation*) and to consult the SBA concerning the impact of such regulations on small businesses (*USC*, 2010, Title 41, Section 405a). Among other measures to promote small business, the OFPP established the position of the Deputy Administrator “with responsibility for small business contracting to ensure appropriate and consistent senior level attention on small business matters” as well

³⁹ The *Small Business Act* also charges OFPP with responsibilities for attaining small business goals (*USC*, Title 15, Section 644(g)(1)).



as “a Small Business Team to focus on small business regulatory issues in the *Federal Acquisition Regulation (FAR)* and improve the efficiency and effectiveness of regulatory development for small business issues through improved coordination and communication between SBA and the *FAR* regulatory drafters” (Denett, 2008, March 6).

B. The European Approach: Centralized Advocacy, Varied National Implementation

European efforts to create public authorities specifically charged with directing various forms of procurement assistance have been relatively recent – but they are at least as comprehensive as similar efforts in America, if not more. In Europe, small business procurement policies are developed and implemented at three different levels: the European Union level; the level of non-EU European agencies or institutions; and the level of individual EU members, including both national and subnational authorities. At the EU level, small business procurement policy is handled by the European Commission, including its Enterprise & Industry Directorate-General, the European Defense Agency (EDA), and the Community Research & Development Information Service (CORDIS). The EI Directorate-General is responsible for initiatives to support the growth and development of small and medium enterprises (SMEs). Its comprehensive efforts for small business procurement began with the *Green Paper, Public Procurement in the European Union: Exploring the Way Forward*, published November 27, 1996 (EC, 1996, November 27). Following the paper’s publication, the European Commission took official action on small business procurement by issuing *Commission Communication COM (98) 143 final, Public Procurement in the European Union*, on March 11, 1998 (EC, 1998b, March 11). However, the European-level activities to



promote small business procurement have been historically limited to promoting regulatory simplification and fairness in cross-border trade.⁴⁰

To enhance SME participation in policy-making at the EU level, the EC created a special position of SME Envoy with the rank of the Deputy Director-General of the EC Directorate-General of Enterprise and Industry. The SME Envoy promotes the “Think Small First” strategies for public procurement, state aid to enterprises, and R&D activities (embodied in a guidebook by the same title) in activities of EU and Member State agencies (EC Directorate of Enterprise).

European agencies and institutions which are, strictly speaking, not part of the EU structure have also created or adopted procurement policies in support of SMEs. One example is the European Space Agency (ESA), which is an international organization dedicated “to the development of Europe’s space capability” (ESA). as well as to “political efforts to forge a united Europe” and to “building Europe as a political entity” (Petrou, 2008, pp. 143-144, notes 7, 8).⁴¹ The ESA’s ruling Council includes 19 states, including Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom, while Hungary, Romania, and Poland participate in ESA activities under a special agreement for European countries. The ESA created an SME Policy Office, which “manages and coordinates, ESA-wide, application of the SME Policy” and “put in place a number of measures to reinforce the technical capabilities and sustainability of high technology SMEs in order to facilitate their involvement in ESA activities” such as set-asides and subcontracting clauses (ESA).

⁴⁰ See *supra*, note 36.

⁴¹ Petrou cites remarks by former Chancellor of the Federal Republic of Germany Helmut Kohl.



A somewhat different approach was undertaken by the European Free Trade Association. There, the relatively generalist EFTA Surveillance Authority monitors SME-specific assistance measures (European Free, 2008, June 30). A similar approach - assigning SME responsibilities to a generalist organization - is undertaken by the European Defense Agency. There, SME assistance is the focus of the Industry and Market Directorate as part of its responsibilities for enhancement of the European defense industrial base (EDA).

In light of both the EU's traditionally limited involvement in small business procurement and the EU's recent drive to increase such involvement, EU nations and their subnational units created their own individual small business procurement authorities. For instance, procurement-related assistance to SMEs in the United Kingdom is a responsibility of both the Small Business Service (SBS) within the Department of Trade and Industry (currently the Department of Business, Innovation, and Skills), and its Office of Government Commerce (OGC) within the Department of the Treasury. The mission of the SBS, created in 2000, is to facilitate business start-ups and development, while the OGC's strives "to achieve effective competition for government business by simplifying access to the government market place" (UK Small, 2004, November). As part of their mission, both agencies "let the small business community know where to find government opportunities, and make sure that small businesses receive equal treatment when competing for contracts" (UK Small, 2004, November). Concerns have been raised that the SBS "lacked the power and influence required to really give small business a voice at the heart of Government," but the British Government further diminished SBS powers and folded it within the DTI/DBIS (Politics.co.uk). While the SBS successor, DTI/DBIS Enterprise Directorate "retains policy responsibility" for SME procurement assistance (UK Department), OGC is also responsible for "helping achieve delivery of further Government policy goals, including innovation, equality, and support for small and medium enterprises (SMEs)" (UK Office).



C. Comparison

Formal offices or agencies responsible for small business procurement assistance have been widely established in the United States and in Europe. US arrangements for such offices have emphasized their specialization in matters unique to small business, relative independence, direct reporting to top decision-makers such as the President or agency Secretaries, and oversight powers. European arrangements, on the other hand, have emphasized the substantive relationship between small business procurement assistance and other policies, such as innovation or development of domestic industries. Independence and direct reporting to top leadership have not been emphasized. As a result, European small business programs have the potential to be driven by non-small business concerns.



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V. Availability of Suitable Contracts

In the context of public procurement, one of the threshold issues for small businesses is the ability to access contracts suitable to the business capabilities of such enterprises. It goes without saying that such work must be, in fact, available. Whether suitable work is available depends on the size or monetary value of contracts, and, to a lesser extent, on the complexity of geographic and performance requirements. Both US and European authorities have pursued limitations on contract awards in order to assure their suitability for small firms. These approaches have a common “good government” concern over fairness and equality of competition, but there are also many differences.

A. The US Approach: Addressing Contract Bundling and Consolidation

As early as the 1940s and 50s, Congressional leadership recognized that contract bundling, or “the size of various procurements,” was an obstacle to the entry of small firms into the federal market (Saltonstall, 1957, January 25).⁴² During the same time period, the Executive Branch undertook several initiatives to reduce contract size on its own. For instance, in the early years of World War II, the National Defense Advisory Commission (NDAC) sought “[b]roader distribution of war contracts” to small businesses “by allowing subcontracting, split bidding, and joint bidding” (NDAC, 1940, August 14, par. 21,042.10). After World War II, the Executive Branch announced the “regionization program” of the General Services Administration (GSA), under which GSA regional offices would break down the government’s regional requirements into small lots (Shestack & Long, 1950-1951, pp. 426, 434). This program enabled small businesses to compete for small lots or even for parts of small lots, and it enabled local small manufacturers to take

⁴² Saltonstall calls for multiple awards to smaller firms instead of awards based on a single large bid.



advantage of the transportation savings (Shestack & Long, 1950-1951, pp. 426, 434). Today, FAR Part 19 directs contracting officers to ensure equitable opportunity for small firms by dividing “proposed acquisitions of supplies and services (except construction) into reasonably small lots (not less than economic production runs) to permit offers on quantities less than the total requirement” (GSA et al., 2010, Section 19.202-1).⁴³

Legislative policy aimed at reducing contract bundling was, in effect, enacted into law by the *Competition in Contracting Act (CICA) of 1984*.⁴⁴ Interpreting *CICA*, the Comptroller General opined that bundling of contract requirements in excess of the agency’s minimum needs to have the requirements performed together violated *CICA*’s requirement for full and open competition.⁴⁵ *CICA* anti-bundling protections apply both to large and small firms, and bundling in violation of *CICA* is impermissible even if the requirements are bundled in a small business set-aside contract that excludes smaller small businesses (qualified under a NAICS code with a smaller size standard cap) in favor of larger small businesses (qualified under a NAICS code with a larger size standard cap).⁴⁶

Finally, Congressional anti-bundling policy was explicitly enacted into law by the *Small Business Reauthorization Act of 1997*, which amended the *Small Business Act* at Title 15, Section 632(o) of the *United States Code*.⁴⁷ The *Small Business Act* defined contract bundling to mean “consolidating two or more procurement requirements for goods or services previously provided or performed under

⁴³ There is a disagreement within the Executive Branch as to whether partial small business set-asides resulting from severability of contracts into lots can be implemented in multiple-award contracts or services contracts (see Acquisition, 2007, January, p. 299, note 116).

⁴⁴ See Public Law No. 98-369 (1984), codified for defense agencies in *USC* Title 10 §§2304 and 2305 (2010), and for civilian agencies in *USC* Title 41 § 253 (2010).

⁴⁵ See, e.g., *Pacific Sky Supply*, B-228049, 87-2 CPD ¶ 504 (Comp. Gen. Nov. 23, 1987); *Phoenix Scientific Corporation*, B-286817, 2001 CPD ¶ 24 (Comp. Gen. Feb. 22, 2001).

⁴⁶ See *Vantex Service Corp.*, B-290415, 2002 CPD ¶ 131 (Comp. Gen. Aug. 8, 2002).



separate, smaller contracts, in a solicitation of offers for a single contract that is unlikely to be suitable for award to small business.”⁴⁸

The Act called on the agencies to pay particular attention to factors “that might cause unsuitability for award to small business,” such as “the diversity, size, or specialized nature” of performance called for in the contract, the total dollar value of the contract, the geographic spread of performance, or a combination of these factors (*USC*, 1998, Title 15, Section 632(o)). To reduce contract bundling and the resulting denial of opportunities for small firms, the Act directed “each federal department and agency, to the maximum extent practicable, to: (1) structure contracting requirements to facilitate competition by and among small business concerns, taking all reasonable steps to eliminate obstacles to their participation; and (2) avoid unnecessary and unjustified bundling of contract requirements that may preclude small business participation in procurements as prime contractors” (*USC*, 1998, Title 15, Section 632(o)). Contracts set-aside for small businesses are not considered bundled under the *Small Business Act*.

In 2002, then-President George W. Bush placed a renewed emphasis on reducing contract sizes with his Small Business Agenda and one of its major

⁴⁷ Pub. L. No. 105-135 (1997), codified in *USC* Title 15 § 632(o) (1998). This law was cited as legislative authority on p. 2 of the *Contract Bundling Report* (OFPP, 2002, October 29).

⁴⁸ The *Contract Bundling Report* (OFPP, 2002, October 29, p. 2) cites *USC* Title 15 § 632(o) (1998). Specifically, Title 15, Section 632(o) of the *United States Code* provides the following definitions:

(1) Bundled contract. The term "bundled contract" means a contract that is entered into to meet requirements that are consolidated in a bundling of contract requirements. (2) Bundling of contract requirements. The term "bundling of contract requirements" means consolidating 2 or more procurement requirements for goods or services previously provided or performed under separate smaller contracts into a solicitation of offers for a single contract that is likely to be unsuitable for award to a small-business concern due to - (A) the diversity, size, or specialized nature of the elements of the performance specified; (B) the aggregate dollar value of the anticipated award; (C) the geographical dispersion of the contract performance sites; or (D) any combination of the factors described in subparagraphs (A), (B), and (C). (3) Separate smaller contract. The term "separate smaller contract", with respect to a bundling of contract requirements, means a contract that has been performed by 1 or more small business concerns or was suitable for award to 1 or more small business concerns.



elements, the Initiative Against Contract Bundling. This Initiative was driven not only by social goals, but also by economic and “good government” goals. At the core, the President’s interest in reducing the size of contracts was grounded in his vision to create “The Ownership Society” (Bush, 2002, March 19).⁴⁹ Kicking off his Small Business Agenda in the speech at the Women’s Entrepreneurship Summit in Washington, DC, President Bush underscored the centrality of the social element to small business contracting: “I believe—I know government contracting, if wisely done, can help us achieve a grand national goal, which is more ownership in more communities all across America” (Bush, 2002, March 19). According to President Bush, the achievement of that goal rested on making the government contracting system “more fair to small businesses” by combating the “effective exclu[sion]” of small firms due to “massive requirements” of contracting agencies (Bush, 2002, March 19). At the same time, the President’s Small Business Agenda emphasized that small businesses provide outstanding economic benefits such as innovation and savings to the taxpayers

(www.whitehouse.gov/infocus/smallbusiness/taxpayer.html).

By October 2002, the Office of Federal Procurement Policy responded to the President’s direction by preparing a report entitled *Contract Bundling: A Strategy for Increasing Federal Contracting Opportunities for Small Business* (hereafter the *Contract Bundling Report*) (OFPP, 2002, October 29). The *Contract Bundling Report* listed additional considerations in favor of reducing contract size so that more work would be available to small firms. The *Report* made clear that rampant contract bundling and poor implementation of the 1997 anti-bundling legislation hurt both the Federal government and America’s small business sector during the 1990s:

Although contract bundling can serve a useful purpose, the effect of this increase in contract bundling over the past ten years cannot be underestimated. Not only are substantially fewer small businesses receiving

⁴⁹ “Small business ownership is the great equalizer in America” (Bush, 2002, March 19).



federal contracts, but the federal government is suffering from a reduced supplier base. American small businesses bring innovation, creativity, competition, and lower costs to the federal table. When these businesses are excluded from federal opportunities through contract bundling, our agencies, small businesses, and the taxpayers lose. (Styles, 2002, October 29)

The *Contract Bundling Report* cited statistics that demonstrated the severe anti-competitive effect of bundling on the viability of the federal contractor base. Thus, according to the data from the SBA Office of Advocacy cited in the Report,

for every 100 'bundled' contracts, 106 individual contracts are no longer available to small businesses. For every \$100 awarded on a 'bundled' contract, there is a \$33 decrease to small businesses. Because these types of contracts 'run longer and encompass a greater scope, competition is reduced in terms of frequency and the number of opportunities.' (OFPP, 2002, October 29, pp. 3-4)

The *Report* also documented "[a] sharp overall decline in new contract awards" to small business even though the total small business dollars remained relatively constant (OFPP, 2002, October 29, p. 4). Other trends discussed in the report included a significant drop in the number of small businesses receiving Federal contracts and growth of orders under existing contracts, especially multiple award schedule contracts and other task order contracts, which have been widely considered as sheltered from small business considerations (OFPP, 2002, October 29, p. 4). At the same time, the *Report* acknowledged that the anti-bundling strategy "must recognize the combined challenges and benefits of a reduced acquisition workforce and the need to maintain an overall acquisition system that is fair, efficient, and transparent. We cannot afford to revert back to the paperwork and labor-intensive system of the past. Nor can we pursue operational efficiencies at the expense of reducing small business opportunities (OFPP, 2002, October 29, p. 4). The overall challenge facing the anti-bundling initiative is "to find an appropriate balance between operational efficiency, opportunity, and fairness (OFPP, 2002, October 29, p. 4).



In the *Contract Bundling Report*, the Office of Federal Procurement Policy outlined an action plan to deal with contract bundling in the Executive Branch. This plan included

accountability of senior agency management for improving contracting opportunities for small businesses” through periodic reports on bundling to, the Office of Management and Budget, and the Small Business Administration; reporting of contract bundling information through the President’s Management Council, composed of deputy heads of 26 major federal executive agencies; regulatory proposals to require contract bundling reviews for task and delivery orders under multiple-award contract vehicles; regulatory changes, in consultation with the SBA and the agency OSDBUs, to provide for review of acquisitions between \$2 and \$7 million for contract bundling; and additional regulatory changes to identify “alternative acquisition strategies for the proposed bundling of contracts above specified thresholds and written justification when alternatives involving less bundling are not used. (OFPP, 2002, October 29, p. 10)

The *Report* also called for greater efforts to mitigate the effects of contract bundling, such as increased compliance with subcontracting plans by making compliance a factor in future awards; facilitation of small business teams and joint ventures, (e.g., by extending the time necessary to organize teams for particular procurements; identification of best practices for maximizing small business Opportunities; and dedication of the agency OSDBUs to the President’s Small Business Agenda) (OFPP, 2002, October 29, p. 4).

Congress took further action to reduce contracts unsuitable for small firms by enacting special restrictions on contract consolidation by the Department of Defense in Section 801 of the *National Defense Authorization Act for Fiscal Year 2002*, adopted in 2003 as Public Law 108-136, and codified at Title 10, Section 2382 of the *United States Code*.⁵⁰ This statute generally prohibits consolidation of two or more contract requirements totaling over \$5 million unless appropriate market research was conducted, alternatives to consolidation were identified, and senior-level

⁵⁰ See P.L. 108-136.



determination was made that consolidation was necessary and justified. *CICA* and other contract bundling or contract consolidation statutes are implemented in the SBA Government Contracting Programs regulations, the *Federal Acquisition Regulation (FAR)*, and the *Defense Federal Acquisition Regulation Supplement (DFARS)*.⁵¹ In October 2007, the Department of Defense published a *Benefit Analysis Guidebook: A Reference to Assist the Department of Defense Acquisition Strategy Teams in Performing a Benefit Analysis Before Consolidating or Bundling Contract Requirements* (DoD Office, 2007, October). The Senate Committee on Small Business and Entrepreneurship sought to extend these restrictions to civilian agencies during the 108th Congress (US Congress, 2003, Section 401), and again during the 111th Congress (US Congress, 2010, Section 102). The United States, however, never adopted a uniform policy against contract bundling or consolidation in state and local procurements.

Anti-bundling efforts in the United States appear to have stalled at take-off. While most regulatory changes called for by the *Contract Bundling Report* have been implemented, the Government Accountability Office issued a report declaring the impact of the Initiative uncertain because of poor accountability measures (GAO, 2004, May 27). Indeed, top-level accountability on reduction in contract bundling and consolidation has been continuously lacking. For instance, on August 3, 2006, then-Deputy Director for Management of the White House Office of Management and Budget Clay Johnson III wrote a letter to then-Senate Committee on Small Business and Entrepreneurship Chair Olympia J. Snowe with promises to develop a scorecard to monitor small business goal achievements as well as reductions in contract bundling (Johnson, 2006, August 3). Unfortunately, the Small Business Procurement Scorecards subsequently released by the SBA and the White House under President George W. Bush and President Barack H. Obama contained no

⁵¹ See, e.g. (CFR, 2010, Title 13, Section 125.2; GSA et al., 2010, Sections 6.101, 7.103, 10.001, and 19.202-1; OSD, 2010, Sections 207.170, 219.201).



measurements related to contract bundling (Preston & Denett, 2006, November 14; Ott, 2007, January 10). However, the Obama Administration issued a memorandum directing Federal agencies to solicit industry input on “requirements were grouped inconsistent with the way services are commonly performed or provided by industry, or otherwise bundled to make it difficult for small businesses to compete” (Field, 2009, October 27). Finally, Section 820 of the *National Defense Authorization Act for Fiscal Year 2010* requires contracting officers to publish justifications of contract bundling and explanations of any benefits derived on any bundled contracts which use Department of Defense appropriations.⁵²

B. The European Approach: Addressing Contract Suitability

In Europe, one of the driving principles behind the procurement system of the EU and its Member states is “equal treatment.” With regard to the suitability of SMEs, some European commentators have argued that this principle means equal treatment to companies regardless of not only their geographic origin, but also economic power or size.⁵³ This interpretation has been explicitly recognized in a recent policy study performed by EIM Business and Policy Research Company with commission by the Enterprise Directorate-General of the European Commission.⁵⁴ The study cited the *Sixth Report (2000) of the European Observatory for SMEs*,

⁵² Public Law 111-84 (Oct. 28, 2009).

⁵³ See, e.g. Martin Burgi, *Small and Medium-sized Enterprises and Procurement Law – European Legal Framework and German Experiences*, 4 PUB. PROC. L.REV. 284 (2007) This would be the case for example, if SME tenders, in contrast to tenders of major companies, were verified as most economically advantageous tenders only because of a financial or other economic preference for SMEs. This procedure would infringe the provisions of the Public Sector Directive and the Utilities Directive, since the contract award criteria for the most advantageous economic tender must refer only to the subject-matter of the public contract in question. Generally admissible criteria such as service and on-call maintenance can have an SME-friendly effect, however. Because of the danger of indirect discrimination, award criteria may only be justified by arguments that are linked to the subject of the public contract in question and not by the argument of SME friendliness or local settlement. The contrary position is argued by Ciara Kennedy-Loest, *Spreading Contract Work to Ensure Security of Supply and Maintain Competition: The Issues Under the EC Directives*, 2 PUB. PROC. L. REV. 116 (2007) (arguing that procurement measures favoring SMEs at contract size, teaming, qualification, award, and performance stages could be justified on a case-by-case basis because they would carry out the objective of “opening up of public procurement to competition” as stated in the Public Procurement Directive 2004/18/EC);

⁵⁴ See generally, *EIM Final Report* (EC, 2004, March).



which identified “the larger size of the contracts” as one of the key obstacles faced by small business in Europe, thus drawing the following conclusion: “It appears that the most important reason why SMEs do not try to participate in European tenders is that the projects are too large” (EC, 2004, March, p. 2).

According to the EIM study of 2001 data, a typical SME contract award equals €249,000, while a typical large enterprise award equals about twice that—€453,000. The median size of contracts advertised on Europe’s TED database is somewhere between the two—€345,000. According to the same database, the buyers with the most SME-friendly median are the armed forces (at €281,000), while local authorities tend to have somewhat higher medians (€306,000). Because 60% of TED-advertised contract awards were made by local authorities, these authorities have the most ability to improve contract opportunities for small business by reducing contract size (EC, 2004, March, p. 15).

Historically, Europe has not had a unified policy on contract size reduction. The EIM study found that while about 85% of public authorities surveyed try to provide size reduction assistance, the extent of these efforts varies widely among different Member States. While over 90% of French and German authorities consider size reductions, only 30% of Dutch authorities consider such reductions. According to the EIM study, “[t]hroughout Europe, hardly any calls for tender are *divided into smaller lots* In twelve of the Member States [including U.K., Sweden, Spain, Portugal, Netherlands, Italy, Ireland, France, Finland, Denmark, Belgium, and Austria], this is done casually (whereby France is characterized by an increasing tendency towards the division of public procurement contracts into lots), in two of them (Luxembourg and Greece) none of the tenders are divided. Only in Germany, division of tenders into lots is done often, resulting in a comparatively small average contract size” (EC, 2004, March, p. 79). Coupled with the fact that Ireland was reported as having the highest median contract award (EC, 2004, March, p. 216), this data suggests that larger European nations tend to be much better at breakouts than smaller nations.



Recently, however, both the EU and national authorities began a concerted effort to pursue break-ups of consolidated contracts (also known as contract splitting) as a major tool of procurement assistance for SMEs. “To a varying extent, contracting authorities have increasingly started to bundle their demands [...]. [T]he contracting entities can easily, without legislative change, create an SME-friendly environment by abandoning or dismantling such [bundled] structures. [...] If the responsible contracting officer does decide to purchase this demand by a central purchasing body or by advertising an extensive framework agreement, the SME-endangering effect could be neutralized by a division of the resulting contracts into trade-specific or partial lots” (Burgi, 2007, p. 290). For instance, as stated above, Article 11 of the European Defense Agency’s 2006 *Code of Best Practice in the Supply Chain* calls for participation of SMEs and other qualified suppliers in procurements “where competition is efficient, practical, and economically or technologically appropriate on a level-playing field basis.” Further, the *Small Business Act for Europe* stated that “Member States are invited to [...] encourage their contracting authorities to subdivide contracts into lots where it is appropriate and to make sub-contracting opportunities more visible, [as well as to] remind their contracting authorities of their obligation to avoid disproportionate qualification and financial requirements” (EC, 2008, June 25, pp. 10-11). Based on express but general authorizations in the Public Procurement Directives, the *European Code of Best Practices Facilitating Access by SMEs to Public Procurement Contracts* advocates three strategies to overcome SMEs’ difficulties related to the size of large government contracts: (1) sub-dividing of contracts into lots and authorizing contractors to compete for unlimited number of lots; (2) grouping or teaming of small contractors;⁵⁵ and (3) conclusion of framework agreements, known in the United States as multiple-award contracts, with SMEs in addition to agreements with large

⁵⁵ “From an SME point of view, this instrument is very interesting as a tool for their promotion, especially if it is ensured normatively or by means of the contracting authority’s behaviour that groups of economic operators are as equally treated as single bidders. The Procurement Directives expressly legitimise the formation of groups of economic operators” (Burgi, 2007, p. 290). Burgi is citing Article 4(2) of the Public Procurement Directive.



businesses. According to the *Code*, the first strategy was supported by laws or best practices from countries including Austria, France, Hungary, Romania, Lithuania, and Ireland.⁵⁶ Likewise, the *Code* provided that the second strategy was supported by the EU business partnering initiative called the Enterprise Europe Network.⁵⁷ The third strategy, per the *Code*, was supported by laws or best practices from the UK,

⁵⁶ Specifically, the 2008 EC *Code of Best Practices* provides on pages 6-7:

National law. According to Austrian law, contracting authorities have the freedom to decide whether to award a global contract or to sub-divide it into separate lots. When taking such a decision, they have to take into account economic or technical aspects. In France, in order to attract the widest possible competition, the general rule is to award contracts in the form of separate lots. However, contracting authorities have the freedom to award global contracts if they consider that the sub-division into lots would, in the given case, restrict competition, or risk to render the execution of the contract technically difficult or expensive, or if the contracting authority would not be in a position to ensure the co-ordination of the performance of the contract. The promotion of the sub-division of contracts into lots is accompanied in some Member States (Hungary, Romania) by provisions of national law which specify that the selection criteria must be related and proportionate to the individual lots and not to the aggregate value of all lots.

Practices. In Ireland, as in other Member States, it is the practice of many contracting authorities when advertising large construction contracts to advertise and award contracts for some of the specialist aspects (electrical services, mechanical services, specialist fitting contracts, etc.) separately to economic operators who are required to work together with the economic operator which has been awarded the contract for the co-ordination of the whole project. This practice facilitates participation by SMEs, while the contracting authority does not have to deal with the challenges that arise from co-ordinating the execution of the different lots. In Lithuania, the public procurement office carries out an ex-ante analysis of contract notices before they are sent for publication in the TED-database and, as part of this analysis, it recommends to the contracting authority to consider sub-dividing the contract into lots.

Indeed, German law appears to require not only the splitting of prime contracts into partial and trade lots in order protect SME interests, but also requires contracting officers to obligate prime contractors to conduct competitive subcontracting of the prime contractors do not subdivide their contracts into such lots (Burgi, 2007, p. 290). Burgi is citing Gesetz gegen Wettbewerbsbeschränkungen [German Act Against Restraints on Competition], 26 August 1998, BGBl. I at 2546, § 97(3) (F.R.G.)). In France, “Article 10 of the Public Procurement Contracts Code establishes the following principle: ‘in the interests of the broadest possible competition, and unless the object of the contract does not lend itself to the identification of distinct lots, the contracting authority may award the contract in separate lots.’ The main aim of this article is to make public procurement more accessible to small and medium-sized enterprises (SMEs) not necessarily equipped to perform the full extent of a public contract” (French Ministry, 2007, July).

⁵⁷ Specifically, the 2008 EC *Code of Best Practices* provides on page 8:

Practices. SMEs may benefit from the advice and support of the easily accessible members of the Enterprise Europe Network (EEN) located in Member States. Launched in 2008, the EEN offers support and advice to businesses across Europe and helps them make the most of the opportunities in the European Union. Its services are specifically designed for SMEs but are also available to all businesses, research centres and universities across Europe. It provides information on EU legislation, helps find business partners, offers possibilities to participate in innovation networks and provides information on funding opportunities (see: http://www.enterprise-europe-network.ec.europa.eu/index_en.htm).



Germany, and Romania.⁵⁸ The *Code* also advocates greater visibility of subcontracting opportunities and greater equity in subcontracting. This strategy was supported by best practices from Romania, the UK, and Germany.⁵⁹ Similar pro-SME contract splitting and multiple-award framework agreements are recommended by the UK Office of Government Commerce as measures to overcome over-dependency on traditional, large suppliers (UK Office, 2004, July; Kennedy-Loest, 2007).

C. Comparison

It appears that the historic European approach to ensuring the suitability of contracts for small businesses by means of voluntary compliance with system-wide

⁵⁸ The 2008 EC *Code of Best Practices* states at page 9:

Practices. In Romania, the issue of how to ensure that the process of being included into a framework agreement with several economic operators is proportionate has been addressed by way of a guidance document, which points out that the minimum levels of ability required when awarding a framework agreement must be related and proportionate to the largest contract due to be concluded, and not to the total amount of contracts planned for the entire duration of the framework agreement. The U.K. has produced guidance which advises contracting authorities, even if they have a framework agreement in place, to consider how best value for money can be obtained, including the possibility to buy outside the framework agreement if: - short-term market conditions (e.g. an unexpected decrease of the price of a certain product) mean contracting authorities could get better value; - innovative goods or solutions are not represented in the existing framework agreements. In Germany, experience shows that SMEs are well represented in framework agreements that are used to cover recurring needs of contracting authorities for small-scale services or supplies (e.g. printing services). A case study from the U.K. illustrates how a framework arrangement for suppliers of office furniture was set up that included large and small enterprises. Large furniture suppliers were able to achieve economies of scale for standard office furniture, and SMEs were able to provide flexibility in meeting requirements for special items, such as reception and conference room furniture and specialist seating. The latter items are typically specified to a higher standard and will vary from order to order. In this way the contracting authority achieved value for money in both standard and specialist items of furniture.

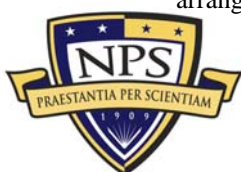
⁵⁹ The 2008 EC *Code of Best Practices* states at page 10:

Practices. The U.K. advises contracting authorities to make subcontracting opportunities more visible to SMEs. Contracting authorities are encouraged to ensure there is visibility of the supply chain by taking a number of measures, such as: - Publishing, on the contracting authority's website, the names of companies acting as prime contractors in a procurement and details of awarded and upcoming contracts; - Where appropriate, contracting authorities are encouraged to ask their main suppliers to demonstrate their track record in achieving value for money through the effective use of their supply chain, including how SMEs can gain access to their subcontracting opportunities. National law. According to German law, the contracting authority has to stipulate in the documentation that the successful tenderer may not impose less favourable conditions on its subcontractors than the



recommendations closely resembled the approach pursued by the United States during the 1940s and the 1950s. Presently, Europeans are transitioning towards hybrid measures which resemble the *Competition in Contracting Act (CICA)* and the Section 801 defense contract consolidation statute in terms of competition standards and break-up remedies, but also resembling the *Small Business Act* in that these measures are invoked specifically (if not exclusively) for the benefit of SMEs. While the two Transatlantic systems share the goal of promoting fairness in public procurement, the United States' anti-bundling efforts are driven by additional considerations of promoting business ownership, ensuring a robust supplier base, and making the economic strengths of small enterprises available to the public sector. It appears that the current US approach on legislative and regulatory standards requiring contracting officers to measure benefits and costs of bundling pursuant to the *Small Business Act* has more “teeth” than the European approach. However, this appearance may be deceptive, as no comprehensive bundling enforcement data was available at the time of this writing. Nonetheless, further strengthening contract suitability policies by legislation appears to be the next natural step for the authorities of united Europe and its Member States as well as for the United States.

conditions agreed on between him and the contracting authority, especially as far as payment arrangements are concerned.



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VI. Small Business Prime Contracting Goals, Set-Asides, and Reservations

In light of the European Commission’s trade rhetoric against SME set-asides and goals, one might expect that SME set-asides do not exist in Europe. Such expectation would be incorrect, as both the United States and Europe have long had small business set-asides, goals, targets, or reservations in various forms.

A. The US Approach: A Tradition of Goals and Set-Asides; Size or Status as Eligibility or Responsibility Criteria

Since the late 1940s, Congress directed agencies to award a “fair share” or “fair proportion” of Government contracts or orders and to provide for “equitable” or “greatest possible” small business participation in a string of procurement statutes, including Section 2(b) of the *Armed Services Procurement Act (ASPA) of 1947*,⁶⁰ Section 18 of the *Selective Service Act (SSA) of 1948*,⁶¹ Section 302(b) of the *Federal Property and Administrative Services Act (FPASA) of 1949*,⁶² Section 701(b) of the *Defense Production Act (DPA) of 1950* (Saltonstall, 1957, January 25),⁶³ and Section 202 of the *Small Business Act of 1953*.⁶⁴ It appears that the “fair share” small business procurement policies were meant to remedy the damage done to the small business sector during the military conflicts of the first half of the Twentieth Century when small businesses were effectively denied the resources and the sales opportunities in defense procurement, and to prevent similar damage in the future

⁶⁰ Public Law 80-413 (Feb. 19, 1948) codified prior to repeal at *USC* Title 41 §151 (1948). Most military-specific small business procurement policies are currently codified at *USC* Title 10 §2301) et seq.

⁶¹ Public Law 80-759 (June 24, 1948).

⁶² Public Law 81-152 (June 30, 1949).

⁶³ Saltonstall (1957) refers to Pub. Law No. 81-774 (Sept. 8, 1950).

⁶⁴ Originally enacted as Public Law No. 83-163 (July 30, 1953).



Shestack & Long, 1950-1951).⁶⁵ As noted by Senator Leverett Saltonstall in his lecture at the Industrial College of the Armed Forces, “[i]n both World War II and the Korean conflict, consideration for the particular needs of small business came too late to prevent damage to their competitive position in the economy” (Saltonstall, 1957, January 25).⁶⁶ Congressional efforts to direct the fair share of government contracts originally did not include a participation goal stated in terms of a defined percentage of total contracts. However, in the absence of a statutory numerical target, the annual portion of small business prime contracts fluctuated widely. In the defense procurement, for instance, these awards ranged from 16% to 32% every year for over 10 years following the end of World War II (US Congress, 1951, p. 11). By comparison, the small business share in defense contracts is currently in the low twentieth percentile (DoD Office).⁶⁷ In 1978, the *Small Business Act* amendments directed the establishment of annual small business procurement goals for federal agencies (Army, 2008, March). The *Business Opportunity Development Reform Act of 1988*⁶⁸ established a government-wide small business prime contracting goal of no less than 20%. The *Small Business Reauthorization Act of 1997*⁶⁹ increased the

⁶⁵ Note, *Utilization of Industry Section of the Selective Service Act of 1948*, 24 N.Y.U. L. Q. Rev. 216 (1949).

⁶⁶ One Congressional report described this problem as follows;

Small business has been unable to obtain a fair share of defense contracts. This is a problem of business life or death to thousands of small manufacturing concerns which have been unable to obtain materials to continue in civilian production. Of course, the path of least resistance is that of loading defense contracts on to large corporations and allowing small business to fall by the wayside. This is the path which was followed in the early years of World War II, when 100 large corporations received 67 percent of prime contracts. During this same period, one-sixth of the small businesses in the Nation closed their doors. This mistake must not be repeated.

Siller Bros., Inc. v. United States, 655 F.2d 1039, 1043-44 (Ct. Cl. 1981), *cert. denied*, 456 US 925 (1982) (citing Report On Defense Production Act Amendments of 1951 (US Congress, 1951), which was reprinted in 1951 US Code Cong. & Ad. News 1626, 1645-46).

⁶⁷ The DoD shows that small firms received 22.375% in Fiscal Year 2009.

⁶⁸ Pub. L. No. 100-656 (1988).

⁶⁹ Pub. L. No. 105-135 (1997), amendment codified at *USC* Title 15 § 644(j) (2010).



government-wide statutory small business goal to no less than 23% of all prime contracts. Congress also established goals for specific small business categories, as discussed below. These goals are codified in the *Small Business Act* at Title 15, Section 644(g) of the *United States Code*.

Congress and the Executive Branch have authorized or required small business set-asides as means to obtain fair share objectives and defense or civilian industrial base objectives. The *Small Business Act* broadly provides in Title 15, Section 644(a) of the *United States Code* that:

to effectuate the purposes [of the Act,] [...] small-business concerns [...] shall receive any award or contract or any part thereof, and be awarded any contract for the sale of Government property, as to which it is determined by the [Small Business] Administration and the contracting [...] agency (1) to be in the interest of maintaining or mobilizing the Nation's full productive capacity, (2) to be in the interest of war or national defense programs, [or] (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 small-business concerns. [...] These determinations may be made for individual awards or contracts or for classes of awards or contracts. (*USC*, 2010, Title 15, Section 644(a))

In 1984, the White House Office of Federal Procurement Policy amended the *Federal Acquisition Regulation* to implement this legislation on a class basis by creating the so-called Rule of Two. The Rule of Two requires the set-aside of any acquisition over \$100,000 “when there is a reasonable expectation that (1) offers will be obtained from at least two responsible small business concerns offering the products of different small business concerns . . . and (2) award will be made at fair market prices” (GSA et al., 2010, Section 19.502-2(b)). For set-asides in the R&D sector, “there must also be a reasonable expectation of obtaining from small businesses the best scientific and technological sources consistent with the demands of the proposed acquisition for the best mix of cost, performance, and schedule” (GSA et al., 2010, Section 19.502-2(b)). The Rule of Two applies to task



order competition in multiple-award contracts (Delex Systems, 2008).⁷⁰ Partial set-asides are also required where a total set-aside is not appropriate, but contracts can be broken up into lots that are appropriate for set-asides (GSA et al., 2010, Section 19.502-3). Further, the *FAR* requires set-asides based on fair proportion, national defense, or national capacity grounds (GSA et al., 2010, Section 19.502-1(a)(1)). The SBA regulations also encourage Federal agencies to consider a small business reservation on multiple-award contracts by “reserving one of more awards for small companies when issuing multiple awards under task order contracts” (*CFR*, 2010, Title 13, Section 125.2(b)(6)(i)(C)).

Over time, Congress began to establish another so-called small business reservation by requiring that small contracts below a certain dollar amount be exclusively set aside for small businesses. The set-aside amount was originally set at \$25,000. In the 1994 *Federal Acquisition Streamlining Act of 1994*, Congress amended the *Small Business Act* to reserve, or set aside, all contracts between \$2,500 (sometimes known as the Micro-Purchase Threshold) and \$100,000 (also known as the Simplified Acquisition Threshold) for awards to small firms in which two or more responsible small firms are available (1994).⁷¹ The \$2,500 MPT has since been adjusted for inflation to \$3,000, and the reservation range was adjusted to between \$15,000 and \$250,000 for contracts related to contingency operations or support of defense or recovery from nuclear, chemical, biological, or radiological attacks (GSA et al., 2010, Section 19.502-2(a)).

Socio-economic goals and set-aside procedures in the *Small Business Act* have been reinforced by special legislation for the Department of Defense, the Coast

⁷⁰ *Accord*, President William J. Clinton’s (1994, October 13) memorandum *Continued Commitment to Small, Small Disadvantaged, and Small Women-Owned Businesses in Federal Procurement* (announcing continued commitment to small business set-asides upon signing of the *Federal Acquisition Streamlining Act of 1994*, Pub. L. No. 103-355).

⁷¹ Pub. L. No. 103-355 (Oct. 14, 1994), implemented in *FAR* 19.502-2(a) (GSA, et al., 2010).



Guard, and the National Aeronautic and Space Administration in Title 10, Section 2323 of the *United States Code*. Among other things, Section 2323 requires these agencies to ensure that contract dollars and numbers of awards awarded under the small business set-aside program are maintained.⁷²

B. The European Approach: Warming Up to Goals and Set-Asides; Effective Set-Asides; Size or Status of Team Members as Award Criteria

Historically, Europeans shied from adopting general small business goals or set-asides at the prime contracting level. Objections in European literature on this subject primarily reflect academic policy arguments such as potential economies of scale, the need to ensure that large businesses are treated no less equally than SMEs, and administrative efficiency, but there is also European literature with contrary policy arguments, such as security of supply, competitive industrial base, and economic development.⁷³ Further, over the last two decades, the European Court of Justice clarified that it is willing to allow set-asides, preferences, or goals based on collateral policies if these policies are endorsed by the European Commission.⁷⁴ This position apparently remains prevalent at this time, and the 42%

⁷² See also *DFARS* Part 219 (OSD, 2010); *Navy-Marine Corps Acquisition Regulation Supplement (NMCARS)* Part 5219 (2010); *NASA FAR Supplement* Part 1819 (2010); and *Homeland Security Acquisition Regulation (HSAR)* Part 3019 (2010). The exception to the normally pro-set-aside procurement regulations is the so-called Small Business Competitiveness Demonstration Program, which forces small firms to compete with large businesses in certain sectors. See *FAR* (GSA et al., 2010) Subpart 19.10.

⁷³ Compare Nicholas Hatzis (2009, pp. 345, 347, n. 10), who cites the European Commission's *Communication to the Council: Promoting SME Participation in Public Procurement in the Community* (EC, 1990, May 7). In that *Communication*, the Commission rejected SME-favoring measures at the prime contracting level such as reservations, set-asides, price evaluation preferences, and "indirect discrimination [which] could arise where SMEs predominate among the enterprises of a region or locality that is itself the subject of preference." The main argument was a criticism of US-style small business preferences on policy grounds such as administrative costs, economies of scale and other competitive benefits of large businesses, and alleged disincentives for modernization and productivity improvements. However, the *Communication* rejected these same arguments in favor of mandatory subcontracting with SMEs.

⁷⁴ In *Communication to the Council: Promoting SME Participation in Public Procurement in the Community* (EC, 1990, May 7), the European Commission has argued that unspecified "certain preference regimes" were



level of SME participation in European public procurement prime contracts as of Fiscal Year 2005 (EC, 2008b, June 25) does not present a compelling case for across-the-board goals or set-asides. However, when it comes to critically important markets such as R&D or the space industry, the Europeans are firmly committed to SME-targeted measures including set-asides and goals. Europeans have, however, provided state aid targeted at SMEs, including SMEs that act as public procurement suppliers. Further, as discussed in other chapters, Europeans prefer to utilize SME participation as one of contract-by-contract socioeconomic criteria included in the value for money award analysis. As further addressed in other chapters, the Europeans prefer to use binding SME subcontracting targets which resemble both goals and set-asides, to be imposed on contract-by-contract basis.

As observed just six years ago, “[s]ince the Competition Law does not allow direct support of access of SMEs to public contracts, policy instruments have to be

contrary to “Community law” and the Treaty based on the European Court of Justice decision in *DuPont de Nemours Italiana Spa v. Unita Sanitaria Locale No. 2 Di Carrara*, Case C-21/88, 1990 ECR I-889. Again, that decision concerned a domestic preference. Further, in *PreussenElektra AG v. Schleswag AG*, Case C-379/98, 2001 2 C.M.L.R. 36, the European Court of Justice distinguished between the invalid requirement that percentage of a product be obtained from a domestic supplier at issue in *DuPont de Nemours Italiana Spa* case from the valid requirements to purchase from renewable energy sources within the supply area of public and private electricity suppliers. The renewable energy requirements were validated thanks, in part, to the policy statements from the European Commission encouraging renewable energy. However, the Communication noted on page 6 that “SMEs increasingly gain access to larger public contracts through sub-contracting [...] [and t]he public procurement directives leave Member States a wide freedom to pursue an active policy of encouraging local sub-contracting.” The Commission found support for SME subcontracting preferences in a European Court of Justice decision which approved the use mandatory contract conditions and award criteria requiring the use of long-term unemployed, provided these conditions/criteria were fully disclosed in advance in the solicitation and were not discriminatory on the basis of nationality. See *Gebroeders Beentjes BV v. Netherlands*, Case No. 31/87, 1988 ECR 4635. Thus, the *Beentjes* case and its interpretation by the Commission appear to be inconsistent with the view that EU-wide SME preferences are contrary to the Treaty.

Like Hatzis in the preceding footnote, Martin Burgi (2007) argued that “[b]ecause of the danger of indirect discrimination, award criteria may only be justified by arguments that are linked to the subject of the public contract in question and not by the argument of SME friendliness or local settlement” (p. 288). Burgi (2007) cites *Contse SA, Vivisol Srl, Oxigen Salud SA v Instituto Nacional de Gestión Sanitaria (Ingesa), former Instituto Nacional de la Salud (Insalud)* Case C-234/03, 2005 ECR I-09315)). However, the case on which Burgi relied again concerns purely the requirements governing the bidders’ location within a local province, and makes no references whatsoever to SMEs. Thus, to date, there appears to be no European Court of Justice precedent precluding SME set-asides or goals in civilian or dual-use procurements as a matter of the EC Treaty.



concentrated on lowering the obstacles for SMEs on the public procurement market” (EC, 2004, March). The European Commission’s procurement directives which regulate acquisitions of various types of products or services in Member States “have been interpreted as allowing for little if any role for policies intended to assist SMEs in the European Community” (International, 2002). This stance is primarily attributable to the Commission’s intent to use the directives in order to secure the benefits of liberalizing national procurement markets. Under this system, SME preferences by national procurement authorities have been disfavored as contrary to the principle of equal treatment of firms from each Member State. Indeed, “[m]ember state programmes designed to provide preferences for domestic firms or restrictions on entry of the firms of other member states in procurement may be subject to challenge by the EC Commission as an infringement of the directives” (International, 2002). The European Commission formerly deemed national-firm preferences on contracts above the European-wide thresholds to be contrary to the requirements of the Procurement Directives then in force (International, 2002).

However, as noted by the International Trade Center of the United Nations Conference on Trade and Development and the World Trade Organization, the Europeans have never been against SME set-asides in principle:

[The European Commission] does not appear to rule out the possibility of preferential measures for SMEs for procurements below the threshold of application as set forth in the directives. For acceptance by the EC Commission, such programmes would likely require clear definitions of qualifying SMEs, compatibility among national regimes, and strict conformity with EC treaty requirements on transparency, equality of treatment, and non-discrimination. (International, 2002)⁷⁵

⁷⁵ *Accord*, Jean-Pierre Jouyet, French Minister of State for European Affairs, Interview with *La Tribune*, (July 5, 2007) <http://www.ambafrance-uk.org/Jean-Pierre-Jouyet-talks-to-La.html> (“Q. – What stage have we got to regarding the possibility of giving SMEs greater access to public procurement? The Minister – We have to find an appropriate legal mechanism allowing us to raise at the WTO the issue of having a European small business act as the Americans did when they



Within the space industry, SME set-asides have a long history at the European Space Agency. ESA has awarded at least two types of SME prime contracting set-asides. The first type of set-asides is the EC-supported “exploratory awards” under €30,000 reserved solely to “non-primers (including SMEs) (Petrou, 2008, pp. 149-150, notes 46-51). The second type of set-asides is the Leading-Edge Technologies from Small and Medium-Sized Enterprises (LET-SME) Announcements of Opportunity up to €200,000 for a period of 6 to 18 months for technical adaptation, testing, or customization of technologies (ESA). The LET-SME set-asides have been in existence since 1998. Politically, ESA set-asides are also related to the principle of *juste retour*, or fair return on investment made by countries towards the ESA budget: “smaller countries tend to receive their fair return through contracts awarded to smaller companies” (Petrou, 2008, pp. 169).⁷⁶

Despite its professed antagonism to US small business set-asides, the EC over time took several steps that make it easier to institute SME set-asides at the prime contracting level. For instance, over the last several years, the EC has explicitly promoted several R&D SME set-aside programs under the framework of Targeted Socio-Economic Research (TSER) (Petrou, 2008, pp. 150, note 48).⁷⁷ In 2006, the EC’s EU Scientific and Technical Research Committee observed that EC rules also provide for SME preferences in the context of state aid, that EU procurement rules are unclear on set-asides, and that “[t]he argument for preferential treatment of SMEs under the Community Framework for state aid for research and development can be similarly applied to public procurement” (EC, CREST, 2006). Also, the EU legal framework apparently authorizes the equivalent

managed to get their own small business act accepted in the WTO negotiations. With Brussels, it’s more a matter of legal adjustment than one of principle.”).

⁷⁶ *Accord, U.K. Space Industry* (UK House, 2000, July 4) “ESA largely (and historically) operates on the principle of ‘juste retour’: the principles that the proportion of contracts under a particular program awarded to firms from a given country is in proportion to the funding that country has contributed to the program.”

⁷⁷ Petrou (2008) cites SME set-asides under the EC’s Fourth and Fifth R&D Framework Programs.



of the low-value small business reservation authority (GSA et al., 2010, Section 19.502-2(a)) in the United States: “Set-asides are legal under European procurement legislation for contracts below European thresholds. However, this use must not discriminate against SMEs from other Member States” (Erridge, 1998, p. 41).

Indeed, although the Public Procurement Directive, the Defense Procurement Directive, and the EC *Code of Best Practices* do not expressly authorize SME set-asides or goals, the directives and the *Code* combined with certain national procurement authorities can have the effect of set-asides for SMEs or teams involving SMEs. The effective SME team set-asides are created by operation of four types of provisions: provisions favoring consideration of social factors in procurement, requirements for mandatory subcontracting with SMEs, provisions encouraging splitting contracts into lots, limitations on lots, and provisions encouraging SME participation groupings of bidders. First, an effective preference or set-aside can be created for SMEs when contracts are split into lots “quantitatively (the size of the lots may better correspond to the productive capacity of the SME) and qualitatively (the content of the lots may correspond more closely to the specialized sector of the SME),” there is a legal limitation on the number of lots any bidder may receive, and government contracting authorities are required to provide extensive documentary justification that at least some SMEs are able to bid for the lots. This appears to be the situation in, for example, Germany under the Public Procurement Directive and German law (EC, 2008b, June 25).⁷⁸ Under the United Kingdom guidance against over-dependency on large suppliers, similar set-asides

⁷⁸ The EC *Code of Best Practices* cites Article 9(5) of 2004/18/EC Public Procurement Directive as authority for splitting contracts. Accord Martin Burgi (2007), who argues that Gesetz gegen Wettbewerbsbeschränkungen [German Act Against Restraints on Competition], 26 August 1998, BGBl. I at 2546, § 97(3) (F.R.G.) creates a preference for SMEs through (1) a legally enforceable obligation to split contracts to fit capabilities and industry specialties of SMEs, (2) requirements for government officials to justify when they do not split contracts or fail to issue small orders under framework agreements; and (3) limits on the number of lots a firm can receive.



could effectively take place.⁷⁹ Further, the EC *Code of Best Practices* promotes as a best practice a UK framework agreement which included awards for SMEs as a way to achieve value for money (EC, 2008b, June 25). Second, an effective set-aside or preference can be created for bidders' groupings that involve SMEs when contracting authorities require that a large contractor subcontracts certain portion of the work to SMEs while modifying Requests for Tender (RFT) to encourage groupings that involve SMEs.⁸⁰

EU Member States appear open to the possibility of instituting SME procurement goals within their nations as well as across Europe. The leading advocate for this sentiment is French President Nicholas Sarkozy, who has taken the position that SME set-asides, goals, and preferences in public procurement are consistent with free trade and competition principles:

Now there are things the Americans do which I've never understood us not doing in Europe. Let me take the Small Business Act: the Americans advocate freedom, but that doesn't prevent them – and I think they're right – from defending small and medium-size companies and reserving a proportion of public procurement for them. I'm not telling you that you are wrong; I'm saying you're right. What do I want for Europe? For us to do the same thing! Because a country needs large groups, but also a fabric of SMEs. You are a great free-trade country, but, in fact, you have adopted different fiscal legislation for products manufactured in your country from those which aren't! I think you're right! Because, after all, it's the State's job to support its companies. (Sarkozy, 2007, November 6)

According to a 2006 comparative procurement survey through the European Public Procurement Network, Austria,⁸¹ France,⁸² Greece,⁸³ and Sweden⁸⁴ have either

⁷⁹ It appears that the UK over-dependency policy guidance permits exclusion of large businesses as sources, which could effectively result in a small business set-aside (UK Office, 2004, July; Kennedy-Loest, 2007).

⁸⁰ Cf. (EC, 2008b, June 25).

⁸¹ European Public Procurement Network's *2006 Survey on National Public Procurement Regulations Favoring SMEs (Small or Medium Enterprises)*: "Question: Is there in your country a regulation that favours or benefits SME's (small or medium enterprises), for example by an obligation or otherwise (like contracts below certain thresholds are only for SME's or 25 % of all contracts by a contracting authority have to be awarded to SME's)?"



already adopted, or have been considering adoption, of SME goals, reservations, preferences, or special considerations. Further, in 2007, French President Nicholas Sarkozy and the French government formally proposed that the European Commission authorize reservations of a portion of EU contracts for SMEs.⁸⁵ The French government has also been seeking to negotiate an exemption from the World Trade Organization Agreement on Government Procurement for contracts set aside for European SMEs (French Ministry, 2009). The set-aside proposal was not made part of the *Small Business Act for Europe*, but the concept of goals remained popular.⁸⁶ For instance, the UK's Labor Government has recently considered imposing an across the board 30% prime contracting goal for SMEs. In March 2008, the Chancellor of the Exchequer created the so-called "Glover Committee" to

Austria: No legal obligation to favor SME's exists. Although in some cases SME's are to be taken in due consideration."

⁸² *Id.* ("France: No: currently not (considering changes) but there are several general provisions that apply to all economic operators but are particularly useful for SME's.")

⁸³ *Id.* ("Greece: Yes, there is a regulation as regards works and research contracts that favors SME's through the obligatory registration of companies in classes depending on their size and the level of the budget of contracts sought. Thus, lower class registered companies can participate in competitions for contracts of lower budget where other, in higher-class registered companies may not.")

⁸⁴ *Id.* ("Sweden: No such regulation, but Sweden has adopted a secondary legislation within the system of government procurement of framework agreements, in which one phrase says: 'In that connection (framework agreements – editors' comment) the possibility of small and medium size enterprises to participate in the procurements shall be considered.'")

⁸⁵ *See, e.g.* France Softens Its Stance on EU Small Business Act, EurActiv.com (Jan. 28, 2008) <http://www.euractiv.com/de/node/219270>. Notably, French President Nicholas Sarkozy campaigned on the promise to set aside US-style small business set-asides, reservations, and preferences in French procurement, and has spoken out in support of "positive discrimination" for SMEs which received 33 percent of French public procurement dollars as of 2007. *See SMEs: Sarkozy Wants Positive Discrimination and Alan Lambert Wants to Remove the Code* (Dec. 10, 2007), <http://www.publictendering.com/en/pme-sarkozy-veut-une-discrimination-positive-et-alain-lambert-veut-supprimer-le-code/>; *Lionel Stoleru: It is Urgent to SMEs with High Potential Into the Global Market* (Jan. 7, 2008) <http://www.publictendering.com/en/lionel-stoleru-il-est-urgent-damener-les-pme-a-fort-potentiel-sur-le-marche-mondial/>. However, his set-aside plans were stymied by the World Trade Organization Agreement on Government Procurement and position of the French Council of State, and he had to settle for monitoring of agency SME contract award trends and more limited preferences at the present time. *Id.*

⁸⁶ *See, e.g.* EurActiv.com, France Softens Its Stance on EU Small Business Act, (Jan. 28, 2008) <http://www.euractiv.com/de/node/219270>.



address this topic (Glover, 2008, p. 3). Ultimately, the Glover Committee concluded in November 2008 that a goal “would not be effective in improving SME participation in public procurement” (Glover, 2008, p. 3). However, that same month, the leader of the Conservative Party, David Cameron, proposed an “aspiration that 25% of Government contracts should be awarded to SMEs” similarly to the US 23% goal (Letsrecycle.com, 2008). Further, in April 2009, the 400-member UK House of Commons All-Party Parliamentary Small Business Group expressly repudiated the Glover Committee’s conclusion concerning SME goals, and called on public authorities to set non-binding, ambitious targets for SME contract awards (UK House of Commons All-Party, 2009, April).⁸⁷

Another “set-aside light” measure gaining popularity in Europe is high-level monitoring of SME participation in public contracts without publicly available goals. Essentially, this is institutionalized oversight by national political leaders designed to pressure government agencies into more contracts for SMEs. For example, since 2006, the French government requires government agencies to measure and report contract awards to SMEs (Ide, 2008).⁸⁸ Likewise, the 2007 *Responsible Purchasing Strategy* issued by the Scottish Parliament calls for regular measurement and reporting of SME contract awards, as well as evaluations of procurement officials on contracting with SMEs (Scottish Parliament, 2007, pp. 14-19). Thus, it appears likely that SME goals and set-asides will be expanded across Europe from R&D and space contracting into other types of procurements.

⁸⁷ The UK House of Commons All-Party Parliamentary Small Business Group includes members in both the House of Commons and the House of Lords.

⁸⁸ “Decree No. 2006-975 of August 1, 2006 amended the French Public Procurement Code for a better access of SMEs to public procurement. The main amendments concerned: a) the subdivision of contracts into lots, b) the creation of more flexible rules for economic operators to prove their technical abilities [...] [and] c) the obligation of purchasers to measure and report on contracts awarded to SMEs.”)



C. Comparison

Without question, the United States has been the leader in applying procurement policy tools such as set-asides, reservations, and goals. However, the Europeans also utilize targeted policies such as set-asides or reservations, although on a smaller scale and in specific industry sectors such as space. Furthermore, the concept of prime contracting goals is currently supported by top leaders in several major European nations. It is likely to see enactment in the near future. Finally, both Europe and the United States have emphasized small business set-asides in space procurements.



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VII. Contracting With Small Firms for Economic Sustainability and Remedial Purposes

Another aspect of small business contracting policy present both in the United States and in Europe is contracting for remedial and sustainability purposes. In this context, authorities in the United States typically direct contracts towards small businesses in certain categories closely related to remedial or sustainability objectives, while the European authorities appear to invoke remedial or sustainability objectives in order to contract with SMEs without further classifying SMEs into special categories.

A. The US Approach: Small Business Socio-Economic Categories

The procurement assistance provisions in the *Small Business Act* are not limited to helping small businesses in general; rather, they reach further to several specific subsets of the small business sector. These subsets include small disadvantaged businesses (SDBs) (i.e., firms owned and controlled by socially or economically disadvantaged individuals or by Native American tribes, Alaska Native Corporations, or Native Hawaiian Organizations), SDBs admitted in the SBA's Section 8(a) Business Development Program, small businesses located in Historically Underutilized Business Zones (HUBZones) and employing HUBZone residents (HUBZone small businesses), small businesses owned and controlled by service-disabled veterans (SDVOSBs), and small businesses owned and controlled by women (WOSBs) (*USC*, 2010, Title 15, Section 644(g)). These groups have been targeted by Congress with preferential measures for a variety of social or economic reasons.

For instance, the HUBZone empowerment contracting program was established to bring market-based economic development to urban and rural



economically distressed areas (Army, 2008). The WOSB small business procurement program was established to address discriminatory underrepresentation of women in certain industries (Army, 2008). The SDVOSB program was established to provide entrepreneurship opportunities for those who sacrificed their health in the service of the Nation (Army, 2008). The SDB and the 8(a) SDB programs were established to provide contracting benefits in recognition of past racial injustices and other discrimination (*USC*, 2010, Title 15, Section 644). Each of these categories has its own set of prime contracting and subcontracting goals established by law or SBA policy (*USC*, 2010, Title 15, Section 644(g)), which are included into the calculation of the overall small business procurement goals.

In addition, Congress and the SBA granted all these categories separate set-asides and other assistance tools (GSA et al., 2010, Part 19). For example, the HUBZone, 8(a) SDBs, and SDVOSB firms may receive contracts on a sole source basis (GSA et al., 2010, Sections 19.801-1, 19.1306, 19.1406). Further, the HUBZone and SDB firms may benefit from price evaluation adjustments in full and open competitions (GSA et al., 2010, Subpart 19.11; Section 19.1307).

SBA regulations set forth legally binding criteria concerning set-asides for small business categories as well as status eligibility of potential contractors (GSA et al., 2010, Subpart 19.3).⁸⁹ Under these regulations, potential contractors can generally protest set-aside decisions of contracting agencies and status or eligibility of their competitors. These protests can be heard by the SBA, the Government Accountability Office, or the Court of Federal Claims depending on the issue.

The Executive Branch implemented additional procurement assistance measures targeted at specific categories of small firms. For instance, President Jimmy Carter issued Executive Order 12073, *Federal Procurement In Labor Surplus*

⁸⁹ FAR Subpart 19.3 (GSA et al., 2010) references SBA status protest regulations for each small business category.



Areas, requiring set-asides for small business located in labor surplus areas (Carter, 1978, August 16). Likewise, FAR Subpart 26.2 currently authorizes set-asides for small businesses located in Federally-directed disaster areas. In 1983, President Ronald Reagan issued Executive Order 12432, *Minority Business Enterprise Development*, directing all agencies with substantial procurement or grantmaking authority to promote procurement from minority business enterprises (MBEs) (Reagan, 1983, July 14). Federal tribunals generally require that race-based preferences be narrowly tailored to further a compelling interest in remedying past discrimination by the procurement agency at issue, but permit wide discretion for preferences based on purely economic factors.⁹⁰

B. The European Approach: Sustainability and Non-Discrimination as Elements of Best Value

In Europe, economic sustainability and remedial considerations have been taken into account on a contract-by-contract basis. Further, while there are no EU-side small business categories, such categories exist at the Member State level.

The *Small Business Concordat: Good Practice Guide*, published by the Office of the UK Deputy Prime Minister on March 1, 2005, provides a good example of such an approach (UK Office of the Deputy Prime Minister, 2005). The *Concordat* is an attempt to guide local government procurements towards integrating socio-economic considerations into the concept of best value for money, which is required by law and which balances “economy, efficiency, and effectiveness” (UK Office of the Deputy Prime Minister, 2005). As explained by the Deputy Prime Minister’s Office,

⁹⁰ Compare *Rothe Development Corp. v. Department of Defense*, 545 F.3d 1023 (Fed. Cir. 2008) (invalidating race-based preferences in Department of Defense contracting for lack of evidence of past discrimination in the legislative record) with *AshBritt, Inc.*, B-297889, B-297889.2, 2006 CPD ¶ 48 (Comp. Gen. 2006) (validating state-specific local preferences for disaster recovery contracting).



[T]he Government's definition of best value is the 'optimum combination of whole life costs and benefits to meet the customer's requirement.' This approach enables sustainability and quality to be taken into account when service delivery options are being considered. For example, the consideration of whole life costs allows factors such as fuel efficiency and replacement cycles to be taken into account, as well as social (e.g. benefits to local people, good workforce management, community safety, diversity and fairness.) Successful procurement strategies are likely to be based on whole life cycle cost considerations that include subsequent revenue implications, and not simply the lowest initial tender price. (UK Office of the Deputy Prime Minister, 2005)

The *Concordat* highlighted a contract clause which imposed the responsibility to contribute to "economic and social regeneration of the locality" in which the service will be performed. The *Concordat* also highlighted the European procurement principles; the *Local Government Act of 2000*, which provided for general powers to English and Welsh authorities to promote "economic, social, and environmental well-being;" and the *Race Relations (Amendment) Act of 2000*, which called for "the need to eliminate unlawful racial discrimination, and to promote equality of opportunity and good relations between people from different racial groups" (UK Office of the Deputy Prime Minister, 2005).

In the UK, remedial and sustainability criteria are also part of the procurement system at the national level. For example, the 2006 *Social Issues in Purchasing Guide* of the UK Office of Government Commerce directs procurement officials to provide procurement assistance to "small and medium-sized enterprises (SMEs), including social enterprises (SEs), black and minority ethnic enterprises (BMEs), women's and disabled-owned businesses, and the voluntary and community sector (VCS)" (UK Office of Government Commerce, 2006, February). BMEs are defined in the Guide as businesses where a single owner with at least 51% stake or multiple owners with at least 50% total stake belong to ethnic groups other than white British. Social enterprises are defined as businesses which reinvest profits back in the business or in the community in order to maximize social objectives. VCS organizations are run by volunteers to provide services that benefit the public, often



acting on behalf of the government. These categories do not necessarily meet the EC definition of SMEs, raising the possibility that SME procurement assistance will be provided to business concerns which are not SMEs.⁹¹

The *Social Issues Guide* also approves the use of procurement selection criteria related to hiring of the unemployed as consistent with the EC Treaty (EC). The *Guide* states that the European Commission will not disapprove of such criteria provided there is no requirement that the unemployed be from a certain area or be registered in national labor agencies (EC). The *Guide* also indicates that such criteria will be sustained by European Court of Justice provided they do not discriminate against suppliers from across Europe in violation of the freedom to provide services and the right of establishment (EC).⁹²

The *Guide* indicates that socio-economic criteria may be used as requirements incidental to a contract objective, as core requirements of a contract, or as award criteria in cases of equal bids. However, procedures to protect the application of these criteria from fraud or abuse appear to be lacking.

Recently, the European Commission again encouraged the use of public procurement for remedial and sustainability purposes. Section 46 of the EC Procurement Directive 2004/18/EC authorizes the use of broad socio-economic criteria as part of “the most economically advantageous tender” procurements awarded on the basis of “best value for money.” The use of socio-economic criteria must be justified:

If these conditions are fulfilled, economic and qualitative criteria for the award of the contract, such as meeting environmental requirements, may enable the contracting authority to meet the needs of the public concerned, as expressed in the specifications of the contract. Under the same conditions, a contracting authority may use criteria aiming to meet social requirements, in response in

⁹¹ Cf. *id.* with *The New SME Definition: User Guide and Model Declaration* (EC).

⁹² Citing *Commission v. French Republic (Nord Pas de Calais)*, European Court of Justice Case C-225-98.



particular to the needs — defined in the specifications of the contract — of particularly disadvantaged groups of people to which those receiving/using the works, supplies or services which are the object of the contract belong. (EC, 2004, March 31, p. 46)

Further, on September 30, 2008, the European Commission's Directorate-General on Competition published a *Vademecum: Community Law on State Aid* (EC Directorate General on Competition, 2008, September 30) containing generous exemptions from restrictions on state aid for purposes of regional development and assistance to SMEs. While those exemptions are beyond the scope of this paper because they were not specifically targeted to SME participation in procurement, they seem to follow the general direction of European SME policies towards more SME-favorable measures. Thus, there is little doubt that the Europeans are intellectually and practically welcoming to the use of socio-economic remedial and sustainability criteria in public procurement.

C. Comparison

It appears that the European and the US procurement systems have been used to advance similar socio-economic goals and objectives such as redressing discrimination against women and minorities, or promoting economic development in distressed areas. Nonetheless, the US system provides clear system-wide criteria for remedial contracting, while the European system contemplates wide discretion by procurement authorities. As a result, the US system appears to be comparatively easier to use by contractors, easier to administer by government agencies, and less likely to be abused by unscrupulous companies misrepresenting their status. The clarity of standards in the US system also helps target remedial assistance to victims of past discrimination while reducing the potential for reverse discrimination. Consideration of sustainability in individual procurement is a task that requires additional administrative resources and creates the potential for greater ad hoc variations or abuse in the conduct of individual procurements.



VIII. Measures to Enhance Transparency and Availability of Public Procurement Information for Small Firms

One other key procurement issue for small businesses everywhere has been the transparency and availability of information about government contract opportunities. Here, again, the European and the US systems appear to be developing largely along the same lines.

A. The US Approach: Maximum Opportunity By Law

Studies conducted in the mid-Twentieth Century by Congress, especially by the Senate Small Business Committee, found that “small firms have difficulty in securing adequate information on proposed procurements or in securing specifications and bid seats” (Saltonstall, 1957, January 25). Congressional leadership insisted that contracting agencies “must provide small firms with every opportunity to be placed on bidders’ lists or to have their products placed on qualified products lists (Saltonstall, 1957, January 25).” In particular, the Senate Small Business Committee expressed doubt that agency “negotiated procurements” provide for full competition, and “continually recommended that negotiation be reduced in as many instances as possible and that advertised procurement become the rule rather than the exception” (Saltonstall, 1957, January 25).

In the United States, Congress and the Executive Branch included numerous legally binding provisions ensuring maximum practicable opportunity for small firms into Federal law and regulations. These requirements cover issues such as forecasting (*USC*, 2010, Title 15, Section 637(a)(12)), publication and notice requirements (GSA et al., 2010, Subparts 5.1, 5.2), regulatory counseling,⁹³

⁹³ See, e.g., *USC* Title 15 §§ 634b and 634c (2010); FAR § 19.202-4(c) (GSA et al., 2010).



interagency cooperation with the SBA (GSA et al., 2010, Subpart 19.4), time extensions (GSA et al., 2010, 19.202-1), uniformity in legal rules, studies and evaluations (*USC*, 2010, Title 41, Sections 405, 405a), determinations of competency or responsibility (*CFR*, 2010, Title 13, Section 125.5; GSA et al., 2010, Subpart 19.6), surety bond guarantees (*CFR*, 2010, Title 13, Part 115; GSA et al., 2010, Subpart 28.2), and obligations of procurement officials to justify restrictive practices that exclude small contractors (*CRF*, 2010, Title 13, Section 125.5; GSA et al., 2010, Subparts 19.2, 19.4).

For example, Section 8 of the *Small Business Act*⁹⁴ requires Federal agencies with over \$50 million in reported contracts to publish annual forecasts of all procurement opportunities by number, anticipated dollar values, time of issuance, and responsible activity. Section 8 of the *Small Business Act* further imposes requirements to electronically publicize notices of contract opportunities over \$25,000 on a government-wide portal and to publicly post notices of lesser opportunities (*USC*, 2010, Title 15, Section 637(e); GSA et al., 2010, Section 5.101). The United States implemented uniform government-wide electronic advertising of contracts at one centralized point of entry, www.FedBizOpps.gov (GSA et al., 2010, Subparts 5.1-5.3). The United States also requires electronic registration of its contractors in order to expedite evaluations and payments (GSA et al., 2010, Subpart 4.11); it merged Pro-Net, the registration database for small businesses interested in bidding for government contracts, into the general Central Contractor Registration database (SBA, 2003, December 23). In order to assist small businesses with obtaining contracts, *FAR* Part 5 established a uniform policy for public advertising of Federal contracts above the micro-purchase threshold across all Federal agencies (with the notable exception of task orders under the indefinite

⁹⁴ *USC* Title 15 § 637(a)(12) (2010) requires agencies to make forecasts available to small businesses, the SBA, and agency OSDDBU offices. Agencies typically make these forecasts available on the internet. See, e.g. US DEPARTMENT OF ENERGY, *Acquisition Forecast* (last visited Feb. 23, 2010) http://smallbusiness.doe.gov/business/acquisition_forecast.htm.



delivery/indefinite quantity contracts) (GSA et al., 2010, Section 5.101). *FAR* Part 5 also requires that solicitations provide adequate citations to laws and regulations which are binding on small business contractors (GSA et al., 2010, Section 5.102).

FAR Subpart 19.2 sets forth further specific transparency and fairness policies to assist small businesses. *FAR* Section 19.202-2 requires government agencies to “make every reasonable effort to find additional small business concerns” before issuing solicitations. Among other things, *FAR* Section 19.202-4 directs agencies to encourage “maximum response” to solicitation from small business concerns by allowing “the maximum amount of time practicable for the submission of offers,” providing specifications, drawings, or related information, and providing points of contact within Federal agencies on contract-specific issues. *FAR* Section 19.202-1 requires agencies to “[e]nsure that delivery schedules are established on a realistic basis that will encourage small business participation to the extent consistent with the actual requirements of the government.” Further, *FAR* Part 19 also references a number of procurement assistance programs overseen by the SBA.⁹⁵ To assist small contractors with their financial capacity, the SBA operates a surety bond guarantee program. *FAR* Section 19.202-1 requires agencies to divide contracts in order to ensure that every small contractor’s work can be guaranteed by the SBA through the surety bond program (*CFR*, 2010, Title 13, Part 115). The SBA Prime Contracting Assistance Regulations at Title 13, Section 125.2 of the *Code of Federal Regulations*, echo many of these requirements and further impose on agencies the obligations to cooperate with the SBA in attainment of maximum practicable participation by small businesses. The SBA may stop non-compliant acquisitions and appeal them to heads of relevant agencies (*CFR*, 2010, Title 13, Section 125.2(b)(7); GSA et al., 2010, Subpart 19.4).

⁹⁵ See, e.g., John R. Tolle, *Small Business Contracting – Part I*, 99-11 BRIEFING PAPERS 1 (Oct. 1999) and *Small Business Contracting – Part I*, 99-12 BRIEFING PAPERS 1 (Nov. 1999).



Further, the SBA's Certificate of Competency (COC) Program provides fair and independent evaluations of small firms who may be discriminated against because they are small. Per Section 8 of the *Small Business Act*, the SBA is responsible for certifying to procurement agencies "all elements of responsibility, including but not limited to, capability, competency, capacity, credit, integrity, perseverance, and tenacity, of any small business concern or group of such concerns to receive and perform a specific Government contract" (*USC*, 2010, Title 15, Section 637(b)(7)(A)). Government agencies are prohibited from passing over small businesses for award on any such grounds without referral to the SBA, and these agencies must accept SBA Certificates of Competency as conclusive (*USC*, 2010, Title 15, Section 637(b)(7)(C); *CFR*, 2010, Title 13, Section 125.5; GSA et al., 2010, Section 19.602-4). Congress found that independent determinations of competency and responsibility through the SBA's COC Program and its predecessor, the Small Defense Plants Corporation capability certification authority, are necessary to ensure not only fair consideration but also fair share of government contracts for small firms.⁹⁶ Small businesses are exposed to prime contracting and subcontracting opportunities through the business matchmaking and procurement technical assistance counseling programs of the Small Business Administration authorized under Section 8 of the Small Business Act. In 1983, Congress passed the *Office of Federal Procurement Policy Act* which directed the White House to issue a uniform *Federal Acquisition Regulation* with due regard for impact on small business concerns and with special procedures pertaining to small business concerns (*USC*, 2006, Title 41, Section 405a). In addition, government-wide and agency procurement regulations are reviewed by the SBA for their impact on small businesses. To promote regulations favorable to small firms, Congress established within the SBA an independent office of the Chief Counsel for Advocacy (*USC*, 2006, Title 15, Section 634a). These efforts resulted in synchronizing rules,

⁹⁶ See *Siller Bros., Inc. v. United States*, 655 F.2d 1039, 1043-44 (Ct. Cl. 1981), *cert. denied*, 456 US 925 (1982) (describing the legislative history of the Certificate of Competency program).



reductions in regulatory burdens and improvements of transparency in government procurement as well as in other aspects of government operations. Overall, the US measures on transparency, fairness, and regulatory relief for small contractors are well-established.

B. The European Approach: Opportunity By Guidance

In Europe, according to the 2004 EIM study prepared for the EC Directorate General of Enterprise and Industry, *SMEs Access to Public Procurement Contracts*, varying regulations and paperwork requirements for public contracts continue to present a major obstacle to successful participation of small business in government contracting (EC, 2004, March). EIM noted the need for increased education about procurement procedures, the need for greater use of e-procurement, and the need to provide fuller information. Even among SMEs successful in public procurement, around 30% of those surveyed in the EIM study do not feel they are properly informed about procurement opportunities.

Publication of business opportunities appears to be the biggest challenge for European small firms, especially those new to the government contracting market. In accordance with the guidance of the European Commission, the “Tenders Electronic Daily” (TED) provides a centralized electronic advertising source for procurements above the Europe-wide monetary thresholds that are required to be published in the “Supplement to the Official Journal of the European Union” (EC, TED). However, authorities such as the UK Small Business Service and Office of Government Commerce acknowledged that procurements below these thresholds may be subject to a wide variety of advertising methods, and that small firms must be skilled in tapping into these resources in order to access government contracts (UK Small, 2004, November).

The European Commission has addressed these concerns in its 2008 *European Code of Best Practices Facilitating Access by SMEs to Public Procurement Contracts*. Among other things, the Code makes recommendations on



SME assistance practices such as ensuring access to information, improvements in quality and understanding of procurement information, proportionality in qualifications and financial requirements, alleviation of administrative burdens, and affording SMEs sufficient time to prepare tenders. The *Code* encouraged European nations to develop single, nationwide procurement portals containing contract documents, as was already done in Estonia, Latvia, and Lithuania (EC, 2008b, June 25).⁹⁷ Electronic tendering facilities are also encouraged. With regards to accessing and understanding procurement information, the Code recommended personalized assistance, information centers, and training programs for SMEs. In addition, the Code emphasized obligations to provide feedback to tenderers as required by the Public Procurement Directives. Finally, the *Code* called for financing and qualification requirements that would not unduly exclude SMEs.

C. Comparison

Again, traditionally, the United States has been the leader in providing transparency, publicity, fair evaluations of competency, and other types of regulatory relief and assistance to small businesses. Continuous leadership of the United States on these issues is, in large measure, ensured by their legally binding nature. However, these types of assistance are not presently central to the US procurement system. Instead, their importance has been eclipsed by the emphasis on goals and set-asides. In contrast, European Member States appear to strongly emphasize regulatory relief-type measures a major element of procurement assistance for their SMEs. The obvious weakness with these European efforts in this area is that they are largely advisory, and there is no obvious mechanism to enforce them for the benefit of specific contractors beyond political mechanisms of the EC and Member State governments.

⁹⁷ The EC *Code of Best Practices* (2008b, June 25) states. “In Latvia, all public tender notices are published on a single web portal which is accessible free of charge and offers daily news service. In Estonia, there is a single online public procurement register for all contract notices which is the sole medium for publishing at national level. Lithuania also uses a single web portal for all contract notices; this offers the possibility for multi-criteria search as well as user interfaces available in Lithuanian and English.”



IX. Subcontracting Goals, Guarantees, and Incentives

A. The US Approach: Non-Binding Assistance Measures

As early as the 1950s, Congressional leadership held the view that “everything possible [should] be done to encourage subcontracting to small business concerns” with regard to “a weapons system concept of procurement” (Saltonstall, 1957, January 25). This sentiment found its way into the Small Business Act, which contains provisions identifying subcontracting goals for various small business categories (*USC*, 2010, Title 15, Section 644) and directing the prime contractors to:

establish procedures to ensure the timely payment of amounts due pursuant to the terms of their subcontracts with small business concerns, 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. (*USC*, 2010, Title 15, Section 637(d))

Section 8 of the *Small Business Act* also directs most large prime contractors to include a clause promising small businesses maximum practicable opportunity for participation in subcontracts (*USC*, 2010, Title 15, Section 644). Further, Section 8 authorizes agencies to offer incentives for subcontracting to small firms.⁹⁸ *FAR* §

⁹⁸ The incentive authority in *USC* Title 15 § 637(d)(4)(E) (2010) provides:

Notwithstanding any other provision of law, every Federal agency, in order to encourage subcontracting opportunities for small business concerns, small business concerns owned and controlled by veterans, small business concerns owned and controlled by service-disabled veterans, qualified HUBZone small business concerns, and small business concerns owned and controlled by the socially and economically disadvantaged individuals as defined in paragraph (3) of this subsection and for small business concerns owned and controlled by women, is hereby authorized to provide such incentives as such Federal agency may deem appropriate in order to encourage such subcontracting opportunities as may be commensurate with the efficient and economical performance of the contract: Provided, That, this subparagraph shall apply only to contracts let pursuant to the negotiated method of procurement.



19.708 also authorizes agencies to provide incentive fees and use small business subcontracting as award evaluation criteria. Some agencies responded to these authorities by creating formal mentor-protégé programs, which gives large businesses that help small firms build capacity various incentives (such as proposal evaluation credits during competitions or the ability to count assistance costs towards subcontracting goals during contract performance).⁹⁹

Further, Section 8 of the *Small Business Act*, as implemented by Subpart 19.7 of the *Federal Acquisition Regulation*, generally requires companies that receive Federal contracts over \$500,000 for products or services and over \$1 million for construction to prepare small business subcontracting plans. These plans are to be based on market research, and are to contain agreed-upon goals for participation of various small business categories. The *Small Business Act* further provides that companies that do not conclude such plans within the time required by the agency will be denied the contract (*USC*, 2010, Title 15, Section 637(d)(4)(B-D)).¹⁰⁰

⁹⁹ See, e.g., US DEPARTMENT OF HOMELAND SECURITY, *Mentor-Protégé Program*, http://www.dhs.gov/xopnbiz/smallbusiness/editorial_0716.shtm (last visited Sep. 16, 2009).

¹⁰⁰ *USC* Title 15 § 637(d)(4)(B-D) (2010) provides:

(B) Before the award of any contract to be let, or any amendment or modification to any contract let, by any Federal agency which— (i) is to be awarded, or was let, pursuant to the negotiated method of procurement, (ii) is required to include the clause stated in paragraph (3), (iii) may exceed \$1,000,000 in the case of a contract for the construction of any public facility, or \$500,000 in the case of all other contracts, and (iv) which offers subcontracting possibilities, the apparent successful offeror shall negotiate with the procurement authority a subcontracting plan which incorporates the information prescribed in paragraph (6). The subcontracting plan shall be included in and made a material part of the contract. (C) If, within the time limit prescribed in regulations of the Federal agency concerned, the apparent successful offeror fails to negotiate the subcontracting plan required by this paragraph, such offeror shall become ineligible to be awarded the contract. Prior compliance of the offeror with other such subcontracting plans shall be considered by the Federal agency in determining the responsibility of that offeror for the award of the contract. (D) No contract shall be awarded to any offeror unless the procurement authority determines that the plan to be negotiated by the offeror pursuant to this paragraph provides the maximum practicable opportunity for small business concerns, qualified HUBZone small business concerns, small business concerns owned and controlled by veterans, small business concerns owned and controlled by service-disabled veterans, small business concerns owned and controlled by socially and economically disadvantaged individuals, and small business concerns owned and controlled by women to participate in the performance of the contract.



The goals for small business participation set forth in these subcontracting plans, however, are not legally binding. The reason is that the Act penalizes only those prime contractors that fail to comply with the plan requirements in “good faith” (*USC*, 2010, Title 15, Section 637(d)(4)(F)(ii)).¹⁰¹ As long as a prime contractor can demonstrate that it conducted outreach to potential small business subcontractors, non-compliance with the goals will be excused under this “good faith” standard. In theory, the penalty for non-compliance includes assessment of liquidated damages (*USC*, 2010, Title 15, Section 637(d)(4)(F)(ii)). In practice, such assessments are virtually unknown.

The SBA has traditionally assigned a 40% government-wide small business subcontracting goal (GAO, 2005, May). According to the SBA, data small businesses received only between 35% and 36% of total subcontracts awarded by large prime contractors on Federal contracts during Fiscal Years 2006 and 2007, and the small business subcontracting share drastically decreased to less than 29% in Fiscal Year 2008 (SBA).¹⁰²

Subcontracting policy in the United States is very unsettled at the present time. In 2005, the US Government Accountability Office (GAO) recommended that agencies should evaluate small business subcontracting based on percentage of total contract value in order to promote integrity, accountability, and meaningful small business participation (GAO, 2005, May). This method is gaining popularity with Federal agencies, as it enables agencies to impose mandatory subcontracting

¹⁰¹ USC Title 15 § 637(d)(4)(F)(ii) (2010) states, “The contractor shall be afforded an opportunity to demonstrate a good faith effort regarding compliance prior to the contracting officer’s final decision regarding the imposition of damages and the amount thereof. The final decision of a contracting officer regarding the contractor’s obligation to pay such damages, or the amounts thereof, shall be subject to the Contract Disputes Act of 1978 (41 USC. §§ 601–613).”

¹⁰² Historically, however, small businesses have been receiving close to 40% of total subcontracted dollars government-wide (SBA, Office of Advocacy, 2006, September).



obligations on large businesses.¹⁰³ However, to date, Congress and the Executive Branch have not yet imposed mandatory subcontracting obligations as a matter of national policy.¹⁰⁴ Further, the GAO recently issued an advisory opinion which interprets the *Small Business Act* to allow for zero small business participation in subcontracting plans at the first tier of subcontracting.¹⁰⁵ Thus, there is a strong possibility that allowing large firms to allot small firms a share of zero subcontracts at the first tier would render the *Small Business Act's* subcontracting provisions meaningless regardless of whether subcontracting obligations are considered to be mandatory or merely “good faith.”

B. The European Approach: Binding Assistance Measures

European efforts to promote subcontracting have traditionally focused on improving access to information about subcontracts. It appears that this approach is being increasingly phased out in favor of requiring prime contractors to comply with mandatory subcontracting obligations.

Traditionally, it seems that Europeans have avoided mandatory subcontracting obligations in their national procurements. As was noted by the British government in 2004, “[t]here is no single way of finding out about

¹⁰³ See, e.g., *Nova Builders*, B-402091, B-402091.2, B-402091.3, 2010 CPD ¶ 33 (Comp. Gen. 2010) (mandatory subcontracting obligations imposed by the US Department of Veterans Affairs); Chair of the US Senate Committee on Small Business and Entrepreneurship Olympia Snowe, Press Release, Snowe: Energy Department to Comply with Small Business Act’s Subcontracting Rules, (June 20, 2005) http://snowe.senate.gov/public/index.cfm?FuseAction=PressRoom.PressReleases&ContentRecord_id=d2f78f20-5dd0-4cee-8dcd-9a3c0e6f3242&Region_id=&Issue_id= (announcing the Department of Energy’s agreement to follow subcontracting measurement recommendations in the Improved Subcontracting Oversight Report, GAO-05-459).

¹⁰⁴ The US Senate Small Business Committee has been attempting to pass legislation requiring total-dollar measurement of subcontracting obligations as recommended in the Improved Subcontracting Oversight Report, GAO-05-459. See, e.g. *Small Business Contracting Revitalization Act of 2010*, S. 2989, 111th Cong. § 201 (2010); *Small Business Contracting Revitalization Act of 2007*, 110th Cong. § 201 (2007); *Small Business Reauthorization and Improvements Act of 2006*, 109th Cong. § 1101 (2007).

¹⁰⁵ See *Northrop Grumman Space and Missile Sys. Corp.*, B-400837, B-400837.2, B-400837.3, B-400837.4, B-400837.5, 2009 CPD ¶ 52 (Comp. Gen. 2009).



subcontracting opportunities, although OGC is encouraging large suppliers to government to make subcontracting opportunities available via their websites” (UK Small, 2004, November).

However, there is also a strong European precedent for mandatory subcontracting set-asides. For instance, the European Space Agency uses the so-called C1 and C3 Clauses which reserve certain subcontracts to non-prime contractors and SMEs. Non-primers do not include large systems integrators dominating European aerospace industry such as EADS and Alcatel-Alenia Space. According to the ESA SME Policy Office, the C1 Clause reserves subcontracting opportunities to “equipment suppliers and SMEs,” while the C3 Clause reserves these opportunities to “SMEs and Research Institutes.” ESA “[p]rocurements where the C1 and C3 clauses are used include those for technology research activities and for the development of equipment, components, or instruments – where SMEs and their partners have the necessary expertise, and there favoring these entities would result in a more efficient use of funds” (ESA). The ESA also uses C2 Clause for non-primers and SMEs and C4 Clause for SMEs on procurements over EUR 250,000. These clauses request large primes to provide for adequate participation of SMEs in terms of quality and quantity, or to justify why such adequate participation cannot be achieved (ESA).

Recently, the European Commission gave its strong endorsement to mandatory subcontracting set-asides. To that end, Article 21(4) of the 2009/81/EC Defense Procurement Directive clearly states: “Member States may provide that the contracting authority/entity may ask or be required to ask the successful tenderer to subcontract to third parties a share of the contract. The contracting authority/entity that imposes such subcontracting shall express this minimal percentage in the form of a range of values, comprising a minimum and a maximum percentage. The maximum percent may not exceed 30% of the value of the contract. Such a range shall be proportionate to the object and the value of the contract, and the nature of



the industry sector involved, including the level of competition in that market and the relevant technical capabilities of the industrial base” (EC, 2009).¹⁰⁶ Recital (3) and Article 73 of the Directive indicate that the Directive is designed to promote SME participation in the industrial base. The mandatory minimum operates essentially as a subcontracting set-aside required of prime contractors. Article 20 of the Defense Procurement Directive also approves the use of subcontracting, including subcontracting driven by social consideration, as conditions of contract performance.

Substantially similar language is found in the 2004/18/EC Public Procurement Directive (EC, 2004, March 31, Section (1), (46), and Article 26). Indeed, the Public Procurement Directive also expressly states that “[i]n order to encourage the involvement of small and medium-sized undertakings in the public contracts procurement market, it is advisable to include provisions on subcontracting” (EC, 2004, March 31, Section (32)). These provisions would, in all likelihood, closely resemble the mandatory minimums approved in the Defense Procurement Directive.

At the same time, the Europeans also treat subcontracting with SMEs as award criteria. Section 1.4 of the EC *Code of Best Practices* states that “contracting authorities are encouraged to ask their main suppliers to demonstrate their track record in achieving value for money through the effective use of their supply chain, including how SMEs can gain access to their subcontracting opportunities” (EC, 2008b, June 25). The EC *Code* also emphasizes national practices such as publication of subcontracting opportunities and legal measures to discourage subcontracting terms that are less favorable than the prime contractor’s terms with the government. Similar guidance is given in the European Defense Agency’s

¹⁰⁶ The Defense Procurement Directive language authorizing mandatory SME subcontracting obligations appears to be means to ensuring “meaningful” participation of European Member States with large concentration of SME defense firms without reliance on the principle of *juste retour*. Cf. Georgopolous (2006, pp. 56-57)(describing the need to ensure “meaningful” participation of national SME defense suppliers).



COBPSC.¹⁰⁷ The EDA further recognizes offsets, including subcontracting requirements to local industry, as one of the best-value award selection criteria (EDA, 2005, November 21).¹⁰⁸

C. Comparison

Subcontracting policies in Europe and the United States are the mirror images of their own policies on prime contracting for SMEs. In Europe, government agencies drive the awards of subcontracts to SMEs in a way that looks very much like legally binding reservations and set-asides at the prime contracting level in the United States. In the United States, on the other hand, subcontract awards to small firms have been promoted largely through “good faith”-based subcontracting plans. Clearly, the European approach will bring more accountability to subcontracting if adopted in the United States. At the same time, the European subcontracting policy of mandatory set-aside minimums demonstrates that Europeans are not as opposed to SME set-asides in principle as the European trade-related complaints about US set-asides may suggest.

¹⁰⁷ Specifically, COBPSC §§ 13, 14, 17 (EDA, 2006, May 15) provide:

In assessing what is economically advantageous in the selection of Suppliers, it shall be taken into consideration that both Buyers and Suppliers need to take strategic sourcing decisions that are wider than individual contract or program requirements. [...] In evaluating tenders of Suppliers, buyers will consider, amongst other things, the approach undertaken or proposed for the selection of sources of supply (including, where appropriate, make or buy plans), having regard to the principles of the COBPSC. [...] Monitoring arrangements will be introduced to assess the extent to which the COBPSC is being applied. It will be based on Prime Contractors providing information on sub-contract opportunities advertised.

¹⁰⁸ The *Code of Conduct on Defense Procurement* (2005, November 21) states, “The fundamental criterion for the selection of the contractor will be the most economically advantageous solution for the particular requirement, taking into account inter alia considerations of costs (both acquisition and life cycle), compliance, quality and security of supply and offsets.” The European Commission defined offsets on defense purchases as follows: “This allows the purchasing country to require a return on investment that may exceed 100% of the value of the contract. Such offsets may be direct, in the form of orders for local companies or transfers of know-



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how and technology related to the original contract. Offsets may also be indirect and concern industrial sectors other than the one covered by the contract in question, even non-military ones” (EC, 2004, September 23).



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X. Use of Public Procurement to Stimulate Small Business Innovation

Innovation is one area in which there appears to be a remarkable convergence in small business procurement policy between Europe and the United States. While the United States exhibited early policy leadership in this area, European states are quickly following suit.

A. The US Approach: Leading on Pro-Innovation Set-Asides

In 1977, the White House Office of Federal Procurement Policy (OFPP) Ad Hoc Interagency Panel on the Role and Difficulties of Small Firms in Selling R&D to the Government published a report, *Small Firms and Federal Research and Development* (OFPP Ad Hoc, 1978, August 9 and 10).¹⁰⁹ This so-called Rabinow Panel was chaired by famous innovator and industrialist Mr. Jacob Rabinow with representatives from the OFPP, the Department of Defense, the National Science Foundation, the National Aeronautics and Space Administration, the Energy Research and Development Administration (predecessor of the Department of Energy) and the Small Business Administration (OFPP et al., 1977, March 10, Appendix I). The Rabinow Panel report found that "small firms receive about 8 percent of Federal R&D awards to industry, and about 3.5 percent of obligations to all R&D performers, including in-house performers of R&D" (p. 432). It concluded that "a striking disparity appears to exist between the capabilities of small technology based firms and their utilization by Federal agencies" (p. 434) and recommended that "Federal agencies should develop formal procedures which encourage the increase of Federal R&D awards to small technology based firms" (p. 436). A year

¹⁰⁹ The OFPP Panel report is included in the record of hearings as Appendix I on pages 429-440, while report of William K. Scheier, Consultant to the Office of Federal Procurement, Office of Management and Budget, Executive Office of the President, *Small Firms and Federal R&D: Background to the OFPP Report of March 10, 1977*, No. OMB/OFPP/CA-77/1 (Feb. 24, 1977) is included as Appendix II, at pages 441-461.



later, the House and the Senate Small Business Committees held hearings to encourage Congressional and Executive Branch actions to address this disparity and implement SME preferences for small R&D firms.¹¹⁰ However, creating such preference on the national level took another four years and direct Presidential leadership.

In 1982, responding to President Ronald Reagan's request, the United States Congress passed the *Small Business Innovation Development Act*, which established the Small Business Innovation Research Program (SBIR). According to President Reagan, "[t]he Small Business Innovation Development Act recognizes that we in government must work in partnership with small business to ensure that technologies and processes are readily transferred to commercial application" (1982, July 22). Ten years later, in 1992, Congress passed legislation to create a supporting program, the Small Business Technology Transfer Program (STTR). Both programs are codified in Section 9 of the *Small Business Act* at Title 15, Section 638 of the *United States Code*. Section 9 is implemented in the SBA's SBIR and STTR Policy Directives.¹¹¹ For SBIR and STTR purposes, commercialization includes sales to the government as well as to the private sector.

In the traditional US set-aside approach, the SBIR Program sets aside 2.5% of extramural R&D funds at Federal agencies with over \$100 million in extramural research and development funds for awards to small business (*USC*, 2010, Title 15, Section 638). The STTR program applies to agencies with over \$1 billion in

¹¹⁰ Statement of Rep. John Breckinridge: "We want to ask: If small business creates more than 1/2 the innovations and does it for 1/2 the cost, why doesn't small business receive more than 1/2 the Federal research and development funds?" (OFPP Ad Hoc, 1978, August 9 and 10, p. 9); *accord* Small Business Technology Council, *Why Are High-Tech Small Businesses So Important to the United States?* (March 1, 2008). http://www.sbtc.org/docs/why_are_high-tech_small_businesses_important_to_the_us_-_final_3-1-08.pdf.

¹¹¹ See US SMALL BUSINESS ADMINISTRATION, STTR POLICY DIRECTIVE, 70 Fed.Reg. 74,925-74,931 (Dec. 16, 2005), with proposed amendment at 72 Fed.Reg. 23405 (April 30, 2007); SBIR POLICY DIRECTIVE, 67 Fed.Reg. 60,071-60,085 (Sept. 24, 2002), as amended by 72 Fed.Reg. 23407-01 (April 30, 2007). The amendments were designed to implement President George W. Bush's Exec. Order 13,329, *Encouraging Innovation in Manufacturing*, 69 Fed. Reg. 9181 (Feb. 24, 2004).



extramural research and development funds, and sets aside 0.3% of such funds for award to small businesses that partner with nonprofit research institutions and Federally-Funded Research and Development Centers (*USC*, 2010, Title 15, Section 638).

To participate in SBIR, SBA regulations require that a company must meet the 500 employee size standards and be majority owned by individual US citizens or permanent residents, or by a venture capital firm which is itself majority-owned by such persons (SBA, 2007, October 18). To participate in the STTR program, the research institution must perform not less than 30% of the work and the small business must perform not less than 40% of the work.¹¹² Three phases of awards are recognized under Section 9: Phase I is used to help a small business turn an innovative idea into an innovative solution meeting the government's interests; Phase II is used to help a small business develop the commercialization of the solution; and Phase III is used for actual commercialization without the help of SBIR or STTR funds but relies on other government funding or private sector contracts (*USC*, 2010, Title 15, Section 638). SBIR or STTR awards may be made using grants, cooperative agreements, or contracts. SBIR and STTR programs include two rounds of competition; however, the SBIR Policy Directive clarifies that companies which received the SBIR awards at Phase I and II to qualify for sole source contracts at Phase III.¹¹³ Thus, the SBIR and STTR programs are hybrids between procurement and non-procurement funding. Within defense procurement, Section 9 authorizes a special SBIR Commercialization Pilot Program (CPP) in order to accelerate transition of small business innovations into defense acquisition programs. Some civilian agencies also have commercialization assistance

¹¹² See STTR POLICY DIRECTIVE, 70 Fed.Reg. 74,925-74,931 (Dec. 16, 2005).

¹¹³ See STTR POLICY DIRECTIVE, 70 Fed.Reg. 74,925-74,931 (Dec. 16, 2005); SBIR POLICY DIRECTIVE, 67 Fed.Reg. 60,071-60,085 (Sept. 24, 2002).



programs.¹¹⁴ The SBIR program generated tremendous return on a relatively modest investment. According to the Small Business Technology Council (Glover), SBIR companies generate approximately 25% of the most important innovations over the last decade while large businesses generate less than 5% and universities approximately 8%. However, small firms generally receive only 4.3% of Federal R&D and the non-SBIR/STTR share of such funding has been declining. Thus, it is clear that the SBIR program is one of the few bright spots in the Federal procurement system that continues to place wasteful and inefficient R&D projects with large, entrenched contractors. However, the SBIR and STTR programs face an uncertain future. In 2008, the SBIR program was validated for reauthorization in *An Assessment of the SBIR Program* conducted by the National Research Council of the National Academies of Sciences (Wessner, 2008). Despite endorsement of the National Academies and support among the small business community, Congress has resorted to short-term extensions for both the SBIR and the STTR programs since the end of September 2009 (US Congress, 2009, October 28, Sections 847, 848; SBTC, 2010, January 28).¹¹⁵ As of early 2010, the United States is in danger of losing these crucial innovation tools due to legislative gridlock.

B. The European Approach: Replicating Pro-Innovation Set-Asides

In Europe, according to another study done under the direction of the European Commission, “almost all countries have adopted measures to promote innovation in general, and in SMEs in particular” (EC Directorate). Based on the study *Innovation Policy in Europe 2004*, it appears that Europeans are deliberately

¹¹⁴ See, e.g. U.S. DEPARTMENT OF ENERGY, *Technical Assistance*, (last visited Feb. 25, 2010) <http://www.er.doe.gov/sbir/CA.html>; U.S. DEPARTMENT OF HOMELAND SECURITY, *DHS S&T SBIR Program: Cost Match Feature* (last visited Feb. 25, 2010) (<https://www.sbir.dhs.gov/CostMatchInfo.aspx>).

¹¹⁵ The *National Defense Authorization Act for Fiscal Year 2010* (US Congress, 2009, October 28, Sections 847, 848) provides for one-year extension of Department of Defense SBIR, SBIR CPP, and STTR programs; Small Business Technology Council (2010, January 28): “This is the sixth [Continuing Resolution or] CR passed since the SBIR program was originally up for expiration in 2008.”



augmenting the principle of equal treatment regardless of company size with the concerted policy to promote SME innovation through public procurement. In particular, the study recognizes “the intention of Sweden to mobilise demand through public procurement by the adoption of a Swedish version of the US SBIR programme” (EC Directorate). The study also observes that “public procurement can play a major part in creating the demand for innovation,” and it noted the plan of the United Kingdom to use the “government’s purchasing power to support innovation” (EC Directorate).

To implement this approach, the United Kingdom established the Small Business Research Initiative (SBRI). As the acronym suggests, the policy model builds on that of the US SBIR. The SBRI imposes a small business procurement set-aside of “at least 2.5 % of [the participating Government Departments’] research and development requirements” (UK Small, 2004, November). The UK initiative also has an overall target of “£50 million of government research to be bought from smaller businesses by 2004” (UK Small, 2004, November). SBRI is a form of “pre-commercial procurement” based on exclusion of R&D from the EC procurement rules (UK Office of Government Commerce, 2009, July). In the UK, the SBRI program is administered by the Technology Strategy Board, a stand-alone government agency funded by the Department of Business, Innovation, and Skills. Just like the SBIR program, the SBRI program has two developmental phases and a third phase involving procurement of a finished product, technology, or service. SBRI awards are contracts, not grants. The SBRI Phase I program concerns feasibility of an innovation, while the SBRI Phase II concerns product development. Phase II participants are chosen through an assessment process at the end of Phase I. At the end of Phase II “it is intended that what has been achieved will be manufactured and purchased by the Department [which established the need for the topic] as a way of fulfilling their procurement requirements” (UK Technology).

The French government also actively promotes set-asides for innovative SMEs. In 2005, then-President Jacques Chirac included SME set-asides and



preferences into his aptly-entitled national R&D policy announcement, *Global Competition for Technological Supremacy*:

[T]he State has a responsibility to promote an environment which is propitious for the development of major industrial projects. This implies having clear strategic priorities: a small number of substantial stimulating programs - concentrated in a small number of key technological areas. It means that everyone involved, SMEs and research laboratories, must network around major enterprises. It implies a European dimension, without which any grand industrial goal would be futile. . . . I'd also like to convey a special message here to the leaders of the top French companies. . . Today, you must enter into a new partnership for progress with our nation. . . . [T]here's a need to bring in the small and medium-sized enterprises, which, alongside you, are making an essential and increasingly essential contribution to growth and innovation. It is up to you to involve them more closely in your research efforts and enter into strategic joint ventures with them. For its part, the State, as the leading purchaser of technology, will undertake to provide incentives: the government will submit a proposal to the European Commission on a mechanism allowing some of the work in technology-related public procurement contracts to be reserved for SMEs. (Chirac, 2005, August 30)

Under President Nicholas Sarkozy, France has continued pursuing measures to promote pro-innovation SME set-asides. These measures included: “raising from €133,000 to €206,000 the threshold for application of the WTO Agreement on Government Procurement” (The Council, 2008, May 14); a 15% procurement participation share for innovative SMEs 2007, December 10), and monitoring of government agencies for their contract awards to small innovative firms (2007, December 10). National SBIR-style programs have also been adopted in Finland¹¹⁶ and the Netherlands.¹¹⁷

¹¹⁶ See, e.g., NATIONAL TECHNOLOGY AGENCY OF FINLAND - TEKES, *Funding and Services for Companies in Finland: Small Businesses*, <http://www.tekes.fi/en/community/Small%20businesses/548/Small%20businesses/1420> (last visited March 1, 2010).

¹¹⁷ See generally, *STRONG: Dutch SBIR Programme* (Kingdom), which announces the Dutch Government's intent to act as a “launching customer” for future high-tech SME suppliers with less than 100 employees.



In fact, the European Commission and other EU-level authorities have been themselves promoting SME innovation set-asides. First, the Public Procurement Directive and the so-called Lisbon Strategy (which called for spending 3% of European GDP on R&D by 2010 in order to make Europe the most competitive place in the world) encouraged national SBIR-type reforms (Kingdom).¹¹⁸ Second, projects set aside for SMEs were funded as part of the European Commission's Framework Programs for Research and Technological Development, as well as the EC's Competition and Innovation Framework Program 2007-2013.¹¹⁹ The latest list of such funding opportunities related to the Seventh Framework Program may be found in the 2008 guide entitled *European Union Support Programs for SMEs: An Overview of Main Funding Opportunities Available to European SMEs*, published by the EC Enterprise & Industry Directorate General (EC Directorate, 2008, November).¹²⁰ Third, the European Commission's *Strategy for a Stronger and More Competitive European Defense Industry* identifies these funding opportunities as a way to stimulate the EU Defense and Technology Industrial Base, pointing out that "[s]pecific provisions have also been introduced to encourage SME participation in the 7th Framework Program for Research in the security thematic research area and through the 'Research for the benefit of SMEs' initiative including, raising the maximum [project costs] reimbursement rate for SMEs from 50% to 75% and introducing simplified participation rules" (EC, 2007, May 12).

C. Comparison

The United States has lead Europe in adopting pro-innovation small business set-asides to ensure that Federal R&D funding is spent more efficiently and does not

¹¹⁸ Citing the exemption for R&D procurements from the 2004/18/EC Public Procurement Directive Art. 16(f) as well as EUR. COMM'N, DIRECTORATE GENERAL FOR RESEARCH, Expert Group Report, *Public Procurement for Research and Innovation* (Sept. 2005), http://ec.europa.eu/invest-in-research/pdf/download_en/edited_report_18112005_on_public_procurement_for_research_and_innovation.pdf

¹¹⁹ See, e.g., Petrou (2008, p. 150, note 48).

¹²⁰ Discussing R&D program cost reimbursement rules.



remain with the same, established contractors. In Europe today, there is a virtual consensus that this policy instrument is necessary to spur innovation and international competitiveness in the manner that is beneficial to the taxpayers and to the SME sector alike. The United States must ensure that it does not squander its international competitive leadership by failing to reauthorize or otherwise support the SBIR and STTR programs.

In terms of program administration, the US SBIR program appears to be more competitive than the British SBRI program. This is because SBIR includes a separate round of competition at Phase II, which gives companies an opportunity to further improve the commercial potential of their Phase I research. The British SBRI program contains a direct link to specific procurement programs of various government departments that were the source for research topics competed at Phases I and II. The US SBIR program, save for the Department of Defense Commercialization Pilot Program, does not appear to have such a strong built-in link. This may in part account for the fact that SBIR traditionally funded R&D which can be also commercialized in the private sector and not merely through government procurement.



XI. Conclusion

A. Implications for Transatlantic Procurement Reforms, US Industrial Base and Innovation Policies, and US-European Trade

The United States has historically lead the way in encouraging the development and growth of small business through public procurement and has reaped substantial socio-economic benefits such as a more competitive industrial base for civilian and defense needs, stronger innovation, and greater economic opportunity. In recent years, the European Union, many of its Member States, and European agencies have sought to vigorously use public procurement in order to achieve similar results in their procurement systems and economies. This effective transatlantic policy competition has enormous implications for procurement, defense industrial base, and innovation reforms on both sides of the Atlantic as well as for the future of US-EU trade relations.

From the standpoint of procurement law and policy reform, the United States and Europe have much to learn from each other's differences and similarities in their small business programs. The US system generally emphasizes features such as: legal certainty and binding nature of small business procurement assistance; sensitivity to industry conditions in small business definitions; multiple anti-fraud and anti-manipulation measures such as a special protest system; independent small business advocates within the government who have top-level reporting and access to government leaders; multiple measures to reduce contract consolidation, including metric targets for benefits from contract bundling; wide-spread use of set-asides, goals, and reservations; clear and binding criteria for remedial and sustainable contracting with small firms; legally binding transparency, fairness, and other good government assistance measures; subcontracting assistance based on voluntary response to incentives or voluntary "good faith" efforts; and competitive, flexible pro-innovation set-asides. On the other hand, the European systems



fostered by the European Commission and the European national policymakers emphasize features such as wide discretion in the use of SME assistance measures; simplified, user-friendly SME definitions for contractors and government officials; voluntary and generalized measures to reduce contract consolidation; emphasis on SME advocacy by procurement officials themselves; reliance on the use of SME participation as an award criterion or as a contract condition; use of set-asides and reservations in targeted circumstances such as framework agreements and space procurements; good government measures related to transparency and fairness; legally binding subcontracting minimum set-aside requirements; and procurement-centered pro-innovation set-asides.

Based on this assessment, policies largely in common across the Atlantic include pro-innovation set-asides, good government and regulatory relief measures, and pro-competitive measures to reduce contract consolidation. The two sides also begin to share common approaches to prime contracting set-asides, goals, and reservations as Europe is expanding these measures across the board. Europe, it appears, is at last firmly embracing the practical utility of these policy tools. However, there are certain differences in approaches across the Atlantic. These differences raise questions of which approach is the more effective. For example, the Europeans' emphasis on transparency and regulatory relief is strong, but its effectiveness is doubtful because these measures are largely confined to non-binding guidance. With the HUBZone program being the notable exception, the US system places more emphasis on achieving positive socio-economic impacts such as jobs creation through the successes of individual small business enterprises, while the European approach addresses the socio-economic impact on a case-by-case basis through award criteria or contract conditions in individual contracts. The European approach is arguably less transparent, and may end up being less effective for that reason. The US tradition of independent advocates dedicated to small business interests and placed within government agencies appears to be a more effective institutional design than the European model of merely requiring



procuring authorities to implement SME-friendly policies. On the other hand, the United States has historically pursued a non-binding subcontracting assistance policy. Such a policy can hardly be as effective as the mandatory minimum set-asides increasingly pursued in Europe. Further, the US small business definitions appear to more accurately reflect a company's relative size within a given industry, while the European system appears to be more user-friendly. The effectiveness of definitions depends on the relative importance of these objectives. Importantly, the European definitions are definitely more supportive of jobs creation than US definitions because the European SME jobs-based size standards measure only full-time jobs created by SMEs. The United States should revise its definitions accordingly. In the end, while the small business procurement policy in the United States appears to be relatively more sophisticated and further advanced, the ever-increasing size of the European common market and the convergence in transatlantic small business policies could compensate for the current limitations of the European approaches.

From the standpoint of US-EU trade relations, it is clear that the Europeans' complaining about the US *Small Business Act* disregards similar European policies and practices. The Europeans have a substantial history of set-asides and reservations in targeted procurement sectors and programs at the prime contracting level as well as subcontracting level. Further, the Europeans have justified these measures based on the needs to increase international competitiveness and to promote a stronger defense industrial base. Accordingly, policymakers in the United States must be mindful of the fact that competing foreign nations consider the *Small Business Act of 1953* to be one of the most powerful industrial base and competitiveness policy tools, and seek to emulate the Act themselves. Indeed, the Europeans seek to emulate the US *Small Business Act* in order to secure global technological supremacy, even though the SME share of European contracts appears to almost double the US share at the present time. This would pose a serious long-term industrial competitiveness challenge to the United States defense



and civilian sectors if the US government fails to maintain strong set-asides and other small business preferences, especially for high-tech small firms. In addition, European SME preferences contain multiple loopholes allowing for fraud and manipulation by large conglomerates, while enforcement measures appear to be lacking. In these circumstances, the United States would be well-justified in refusing European demands to waive or repeal the Small Business Act. Abandoning the *Small Business Act* or opening up US small business procurements to European firms would be shortsighted and detrimental to the US national interests. This does not mean that the United States and Europe cannot ever negotiate a trade agreement to provide reciprocal procurement opportunities to each other's small businesses. However, such cooperation is better suited for limited procurement programs where both sides contribute financially, agree on a common definition of a small business and on related enforcement measures, and devise common assistance tools for small firms. The North Atlantic Treaty Organization (NATO) procurements could be suitable for such an endeavor. Finally, a common-sense approach for proceeding forward would involve the United States maintaining and strengthening the US *Small Business Act* while allowing the European SMEs the same exemptions from the WTO Agreement on Government Procurement that are presently afforded to US small business contracts.



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