



CRS Report for Congress

Possible Small Business Issues in the 110th Congress

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Summary

The four-year authorization for most Small Business Administration (SBA) programs expired on September 30, 2006, and the 109th Congress adjourned without enacting long-term reauthorization legislation. Reauthorization provides Congress with a vehicle for evaluating and amending SBA programs. The 109th Congress passed a temporary measure (P.L. 109-316) extending authorization through February 2, 2007, and H.R. 434 (passed by the House on January 17, 2007) contains a further extension through December 31, 2007. The 110th Congress may take up long-term reauthorization bills as well. This report summarizes several small business issues that Congress may address, either as part of the reauthorization process or otherwise. These include the SBA's disaster loan programs for individuals and businesses, small business contracting goals, the cost to borrowers of SBA-guaranteed loans, access to affordable health insurance, tax issues, oversight of internal SBA management, and the extent to which large businesses win government contracts set aside for small businesses.

This report will be updated as legislative developments warrant.

Small Business Issues

SBA Reauthorization. The 109th Congress considered H.R. 5352 and S. 3778, which would have reauthorized expiring SBA programs and modified many existing SBA programs. Neither bill was enacted before authorization expired on September 30, 2006. Instead, P.L. 109-316 extended authorization through February 2, 2007. On January 17, 2007, the House passed H.R. 434, which would extend SBA programs until December 31, 2007.

Small Business Contracts Awarded to Large Businesses. In the 109th Congress, the minority of the House Small Business Committee and the SBA Inspector General (IG) reported that many government contracts intended for small business were

in fact awarded to large firms.¹ There are three reasons why contracts set aside for small businesses could be awarded to large businesses. First, this could be permitted by current law and regulation under certain circumstances. Second, there could be an honest mistake. Third, there could be fraud.

Proper Awards. Recently many government agencies have set aside long-term, multiple-award contracts for small businesses. Frequently these contracts are very general and offer the winning businesses the ability to compete later for specific task order work. A task order contract allows an agency to make a single contract award through the competitive process, and subsequently contract for specific work (tasks) with little or no additional competition. Many agencies favor this type of contract because it reduces the burden on shrinking procurement staffs. These longer-term contracts provide opportunities for a business to outgrow the SBA size limits, either through winning additional contracts or by merger with other small (or large) firms.

When a business bids on a government contract set aside for small business, an officer of the firm must certify that, as of the date of signing, the business qualifies as small. With certain exceptions, a business remains eligible to fulfill a contract even if it grows too large or is purchased by a non-small business after submission of the proposal.

In late 2006, the SBA issued a final rule (effective June 20, 2007) to require firms with small business contracts to re-certify their small business status (1) at the start of the sixth year, (2) with every subsequent contract renewal, (3) after a merger or acquisition, and (4) with every contract extension.² If a firm is no longer small, it can still win new work under the contract, but such work will no longer count as work awarded to a small business. The SBA stated it was doing this to allow the contract to run for its full term. Prior to this change, a business retained its small business designation for the duration of a contract, although agencies could require more frequent recertifications.

This revised regulation could still allow a large business to compete for and win work set aside for small businesses. Proposals to address this issue include requiring size certifications to be re-signed annually, or on the dates that contracts are awarded and/or modified. Another question is whether a firm that is no longer small should be barred from competing for task orders on a small business set aside contract against firms classified as a small businesses.

Honest Mistakes. The SBA IG issued a management advisory report in March 2006 recommending that the Central Contractor Registry be modified to prevent inconsistencies in claiming small business status that allowed at least one ineligible

¹ House Small Business Democratic Staff, *Scorecard VII: Faulty Accounting by Administration Results in Missed Opportunities for Small Businesses*, July 26, 2006. Available at [<http://www.govexec.com/pdfs/ScoreCardVIIFINAL.pdf#search=%22%22faulty%20accounting%20by%20administration%22%22>]. SBA, Inspector General, *The Central Contractor Registration Needs Large Business and Small Business Designation Improvements*, Management Advisory Report No. 6-18, Mar. 21, 2006, available at [<http://www.sba.gov/IG/6-18.pdf>].

² Small Business Administration, "Small Business Size Regulations," *Federal Register*, Vol. 71, No. 220, Nov. 15, 2006, p. 66434-66444. This modified 13 C.F.R. 121 and 124. The new regulation includes any option periods in determining the length of a contract.

business to obtain a small business contract. Other sources of honest mistakes doubtlessly exist; for example, it is possible that carelessness has caused some contracts in the Federal Procurement Data System — Next Generation (FPDS — NG) to be incorrectly listed as small business.

Fraud. The press has suggested that fraudulent misrepresentation of a firm's size is the reason that some small business contracts were awarded to apparently ineligible firms.³ Abuse of small business programs has been a frequent subject of oversight hearings.

Small Business Contracting Goals. Many small business advocates are concerned that the federal government is not doing enough contracting with small businesses. Overall, the federal government has set a goal of awarding 23% of its contract work with small firms, but each agency negotiates an individual goal with the SBA. Agencies meeting their goals can be nominated for the Gold Star Award, but agencies failing to meet their targets incur no penalties.

Some small business advocates have questioned the accuracy of information in the FPDS — NG that is used to calculate the percentage of contracts awarded by an agency to small businesses. They believe that some large businesses are incorrectly listed as small, which inflates an agency's small business contracting totals. A 2006 report prepared by the House Small Business Committee Democratic Staff discusses these issues in detail.⁴

Revisions to the Definition of Small. There is no uniform definition of "small" business. The SBA determines a *size standard* on an industry-by-industry basis, weighing the number and size of firms in an industry, the degree of competition, barriers to entry, and start up costs. The size standard must be small enough exclude any dominant firms in the industry. Depending on the industry, the SBA sets the size standard based on a firm's number of employees or revenues. For example, the size standard for new single-family home construction businesses is \$31 million of annual revenue, and for iron and steel mills the standard is 1,000 employees.⁵

There have been proposals to increase the size standard to make larger businesses eligible for small business programs. For example, the Department of Defense (DOD) has suggested increasing the size standards because defense contracts frequently push the winning small business over the size standard. This limits a small business to one DOD contract, and the Pentagon would like the flexibility to award additional relatively large contracts to a firm. Many small business advocacy groups have opposed this. On the

³ James Norton, "Don't Divert Small-Business Aid to Big Business," *Christian Science Monitor*, July 28, 2006, p. 9, and Lloyd Chapman, "SBA Charade: Congress Must Stop Letting Corporate Giants Steal from Little Firms," *Rocky Mountain News*, Aug. 26, 2006, p. 2C.

⁴ House Small Business Democratic Staff, *Scorecard VII: Faulty Accounting by Administration Results in Missed Opportunities for Small Businesses*.

⁵ SBA, *Small Business Size Standards Matched to North American Industry Classification System* available at [<http://www.sba.gov/size/sizetable2002.html>]. (The SBA adjusted its dollar measures of size for inflation effective January 5, 2006.)

other hand, there are also proposals to reduce the size standard, in order to eliminate larger small businesses from small business programs.

Disaster Loan Issues. In the aftermath of Hurricanes Katrina and Rita in 2005, many complaints were made about the SBA's performance, most notably its disaster loan program. In particular, many residents of the Gulf Coast complained about the lack of timely government assistance. The SBA's problems in responding were due in part to the magnitude of the natural disaster. Contributing to the delays was the implementation of a new computer program to process disaster loan applications. The SBA has reported that the computer problems have been fixed and that processing capacity has been greatly enhanced. Peak disaster staffing remains a challenge, because the agency does not have the capacity to send significant numbers of regular employees to disaster areas. As an alternative, the SBA has a Disaster Reserve of 1,000 intermittent employees.⁶

Some Gulf Coast businesses suggested that the SBA should supplement its disaster lending with a bridge loan program to fund the purchase of new inventory by retail and wholesale businesses. Bridge loans would be for short periods of time, secured by the inventory. Bridge loan advocates say that they would meet a pressing need with little risk to the government. Opponents say that there would be risks and that it could be difficult to liquidate the inventory if the borrower were to default. They also argue that the program is unnecessary because many states already have such programs.

Loan Fees and Subsidies. The Administration's FY2007 budget proposed changes in the fees and subsidies to SBA loan programs, which have been the subject of much discussion in the past. Interest rates in the SBA's 7(a) guaranteed loan program are reduced below the risk-adjusted market rate. The difference between the risk-adjusted market rate and the loan rate is a subsidy for the borrower. Starting with the FY2005 budget, the SBA increased the fees on 7(a) loan guarantees to cover the cost of this subsidy. The proposed FY2007 budget would increase fees on loans of more than \$1 million to cover administrative costs. Supporters say that the increased fees allow more firms to obtain the loans, while opponents say that the fees make the SBA guarantee too expensive for some firms to afford.

The Administration also proposed in the FY2007 budget that the interest rate on new disaster loans should be subsidized for the first five years, after which it would rise to market rates for the remaining life of the loan (which can be as long as 30 years). Currently, an SBA disaster loan has a capped interest rate for the entire term of the loan.

None of these provisions was included in the SBA's FY2007 appropriations bill (H.R. 5672 in the 109th Congress) as reported in the Senate, but they could be proposed again in the President's FY2008 budget.

Microloan Program. SBA-guaranteed microloans are designed to overcome the relatively high fixed costs of processing small loans and to help inexperienced business owners. They go mostly to new businesses that have little or no track record and little or

⁶ By way of comparison, the SBA's staff for FY2006 was 5,240 full time equivalent employees. Its FY2007 budget requested authorization to reduce this to 2,975. U.S. Small Business Administration, *FY2007 Budget Request and Performance Plan*, p. 23.

no credit history. These loans are too risky for private lenders to make without a government guarantee. The maximum microloan is for \$35,000, but the average is \$10,500.⁷ The more traditional SBA 7(a) program guarantees loans for up to \$2 million. SBA microloans are made by local nonprofit lenders and include business-based training and technical assistance. In many cases, the application process is simpler for a microloan than for other SBA programs.

The Administration's budget for FY2007 (and several years previously) proposed to eliminate funding for this program. Many small business advocates support continuing microloans. The Administration considers the microloan program as too expensive to operate and duplicated by other programs.

Health Insurance. Because of the way health insurance is priced, small groups (including small businesses) usually pay more for similar coverage than large groups. As a result, small businesses are less likely to offer employees health insurance than large businesses. One reason is that the Employee Retirement Income Security Act of 1974 (ERISA) places health care benefits of large employers under federal regulation, while smaller businesses are regulated by their respective states. Smaller multi-state employers find it expensive to comply with the requirements of different states, and some decide not to offer health insurance. Bills in the 109th Congress (H.R. 525, S. 406, and S. 1955) would have placed most plans sponsored by trade and professional associations — called association health plans — under federal regulation. Those opposed to the bills object to overriding state coverage mandates. H.R. 525 passed the House. The Senate debated S. 1955, but a vote to invoke cloture failed. Similar legislation may be introduced in the 110th Congress.⁸

Tax Burden. Small businesses receive special tax treatment in many areas. One tax provision that is important to many small businesses allows them to write off up to \$108,000⁹ of the cost of certain assets in one year instead of depreciating the cost over many years. The amount is indexed for inflation until 2008 when it is scheduled to revert to \$25,000. (This provision is referred to as “Section 179,” after its location in the Internal Revenue Code.) Advocates say that Section 179 encourages business investment and supports small businesses.¹⁰ In addition, proposals to change the impact of the estate and gift tax on family businesses may come before the 110th Congress.¹¹

⁷ [<http://www.sba.gov/opc/pubs/fs68.html>] The date of this average figure is not specified.

⁸ For additional information see CRS Report RL31963, *Association Sponsored Health Plans: Legislation in the 109th Congress*, by Jean Hearne, and CRS Report RL33402, *Side-by-Side Description of Small Business Health Insurance Proposals*, by Jean Hearne and Bernadette Fernandez.

⁹ As of 2006.

¹⁰ CRS Report RL31852, *Small Business Expensing Allowance: Current Status, Legislative Proposals, and Economic Effects*, by Gary Guenther discusses this in more detail, while CRS Report RL32275, *Small Business Tax Preferences: Legislative Proposals in the 109th Congress* also by Gary Guenther covers many tax issues that could come before the 110th Congress.

¹¹ CRS Report RL33070, *Estate Taxes and Family Businesses: Economic Issues*, by Jane G. Gravelle and Steven Maguire fully explores the issues around these proposals.

Internal SBA Management. Every year, the SBA's IG and the Government Accountability Office (GAO) review various aspects of the SBA's internal management and suggest improvements. Any of these issues could come before the 110th Congress, but based on the amount of attention given to disaster assistance, the response to Hurricanes Katrina and Rita may be the most likely issue. The IG also has found that fraud was perpetrated by some recipients of September 11, 2001 disaster loans.

The IG has identified several areas in applications for SBA guaranteed loans that may be vulnerable to misrepresentation. These include (1) the amount of money that a business owner is contributing to a project, (2) whether the owner is a U.S. citizen, (3) fraudulent documentation, including fictitious asset claims and valuations, non-disclosure of criminal records, and misuse of loan proceeds. False statements increase the risk that a business will default on its loans, forcing the SBA to honor its guarantee and increasing the cost of small business lending programs to the taxpayer.