To the "disadvantaged" go the spoils?

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In the summer of 1998, the U.S. Department of Commerce released a controversial study supporting a form of affirmative action for minority-owned businesses. These businesses, when competing to provide goods and services to the federal government, are granted certain bidding advantages over their nonminority-owned competitors. The study, called the "benchmark limits" report, was the culmination of nearly two years of research. It intended to determine the procurement areas where federal agencies could apply a 10 percent "price adjustment evaluation," a euphemism for a bid preference, to "small disadvantaged businesses" (SDBs), which are businesses owned by African Americans, Hispanics, Asian Americans, and Native Americans.

Here's how the system operates: If a non-SDB bids $1,000,000 on a given contract and a SDB bids $1,090,000, the contract would be awarded to the SDB, because its bid was not more than 10 percent over that of the non-SDB's. According to the benchmark study, these bid preferences could be applied
to nearly three-quarters of the $180 billion federal procurement budget.

It is remarkable that a study of such constitutional and budgetary importance was only 12 pages of text and tables. In addition, its inception and development were unusually opaque. But litigation has forced disclosure of some of the study's data, and it is now possible to examine its questionable methodology and conclusions.

Program specifics

Since 1973, the federal government has administered several programs that favor minority-owned enterprises seeking federal contracts. The largest of these programs is the 8(a) business-development program, which sets aside about $6 billion in federal contracts for approximately 6,000 eligible firms. The program is controversial because only a few 8(a) firms have reaped the lion's share of the contracts. In 1995, 1 percent of all 8(a) firms received a quarter of the money designated for the program. Few firms ever graduate from the 8(a) program.

The other major federal program for awarding contracts is the Small Disadvantaged Business (SDB) program. This program offers bid preferences to SDB firms if procurement officers determine that the preferences will be used to meet minority business goals. In 1994, Congress extended the 5 percent quota for SDB contracts, which was being used by the Department of Defense, to all federal agencies.

Both the 8(a) and the SDB programs employ the concept of "presumptive eligibility" to determine which firm owners are "socially and economically disadvantaged." What this means is that any person who is a member of one of the previously mentioned minority groups is automatically considered socially disadvantaged. Firm owners not from presumptively eligible groups can enter the program only if they can prove, with the requisite documentation, that they have been subjected to discrimination. The upshot is that over 99 percent of the 8(a) and SDB firm owners are members of presumptively eligible groups.

In the 8(a) program, to be considered economically disadvantaged, a firm owner must have a net worth of less than
$250,000, excluding the value of the business and residence equity. The SDB program uses a more generous $750,000 limit, with the same exclusions. These limits mean that 80 to 90 percent of the business-owning families in the United States are "economically disadvantaged." Thus the true criteria for 8(a) and SDB certification is "social disadvantage" or membership in a minority group.

In 1995, the Supreme Court ruled, in *Adarand v. Pena*, that "strict scrutiny" be applied to the federal government's use of racial classifications in denying or conferring benefits. In other words, such racial classifications are unconstitutional unless the government has a compelling interest in using them in a narrowly tailored way against flagrant discrimination. This is a very stringent standard. Since *Adarand*, three U.S. district courts have struck down federal transportation programs that were using racial and ethnic preferences.

*Adarand* is an extension of a 1989 Supreme Court decision, *Croson v. City of Richmond*, which applied strict scrutiny to state and local minority procurement programs. Since the *Croson* decision, a variety of other race-based programs, in admissions, employment, redistricting, and contracting, have been found to violate the equal-protection clause of the Fourteenth Amendment. One consequence of the *Croson* decision was that many state and local governments commissioned "disparity studies," which purported to reveal discrimination in the awarding of contracts. Based on these studies, minority set-aside programs were initiated, maintained, or expanded. About 140 studies comparing disparities in the availability and utilization of minority-owned businesses have been completed at a cost of over $55 million. The validity of these studies, when judged by the strict-scrutiny standard, has not been proved in the courts. In fact, none of the studies has survived when subjected to discovery and brought to trial.

**The benchmark study**

In 1996, the Justice Department proposed that "benchmark limits" be created for each industry. These benchmarks were intended to represent the "level of minority contracting that one would reasonably expect to find in a market absent discrimination or its effects." The benchmark limits were also
supposed to guide the decision of whether minority preferences were even necessary for that industry.

In 1998, the benchmark study—the first federal attempt at a disparity study—was released by the Department of Commerce. Since the report was so brief, lacked details about its methods, and did not offer any specific conclusions, Congressional staff members assumed that a more comprehensive follow-up report would soon be made available. When that did not happen (no such document existed), the Senate and House Judiciary Committees asked to meet with the benchmark study’s authors. A meeting was scheduled a few weeks later at the White House, but no Commerce Department personnel attended. The Justice Department and White House officials knew practically nothing about the benchmark study’s methodology, and scarcely any helpful information was exchanged. The Justice Department and White House officials promised that further questions could be faxed to the benchmark study’s authors. The faxed inquiries were never answered.

On the surface, the benchmark study appeared to measure disparities in the availability of SDBs and their use during fiscal year 1996. To account for the different conditions in the various industries, the study based its calculations on two-digit Standard Industrial Codes (SIC). The study found a disparity between SDB availability, or capacity, and SDB utilization in 40 of the 68 comparisons selected. This disparity, said the study’s authors, justified the imposition of the 10 percent bid preferences.

But, upon closer examination, the study is contradictory and implausible. SDBs are, by definition, small disadvantaged businesses. Yet, in several of the Standard Industrial Codes, SDBs were estimated to have an extraordinary capacity to supply federal procurement. For example, SDB capacity was estimated at 33.1 percent in SIC 50 (wholesale trade-durable goods). In SIC 58 (eating and drinking establishments), SDBs were estimated to cover 80.5 percent of the federal government’s required capacity. This suggests that something was wrong with the study’s calculations.

Data-collection problems

Initially, the benchmark study used census data in the form of the Survey of Minority Owned Business Enterprises
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(SMOBE) to measure the availability of minority firms for federal contracts. While many studies on contracting discrimination have been based on census data, not one has survived judicial scrutiny. The data are obsolete. Further, information on which firms have bonding and licensing or which ones are willing to engage in federal contracting is not available in census data. But the Commerce Department did not finally abandon the SMOBE data until a pilot study revealed that the data were insufficient.

The firm Westat was eventually commissioned to collect data on companies that had made bids for federal contracts amounting to more than $25,000. Westat acquired information on approximately 12,600 contracts. Although the benchmark study mentioned the Westat sample, it did not indicate the total number of federal contracts, the distribution of contracts by SIC codes, or whether the sampled contracts adequately represented the corresponding federal agencies. According to the 1996 Federal Procurement Report, there were 460,733 contracts awarded in 1996, though many were valued at less than $25,000.

Using the Westat sample, the Commerce Department determined the number of SDB and non-SDB firms that bid at least once in each SIC (though the department has never released these figures). Then the department took an additional step, which skewed the statistics. It added to the number of SDB bidders all 8(a) firms—whether or not they offered a bid. The resulting distortions are potentially enormous. In SIC 73 (business services), it was revealed during litigation that of the 2,206 SDB firms considered available during fiscal year 1996, 1,497, or 68 percent, were 8(a) firms. Some of those 8(a) firms may have offered a bid, but many did not. Clearly, if a firm does not bid, then it is not really competing for a contract. Furthermore, most 8(a) firms do not bid in open competition; they compete only for reserved contracts limited exclusively to other 8(a) firms, or they receive "sole-source contracts" based on their minority status. In fiscal year 1995, only 4.3 percent of all 8(a) contracts were competitively bid.

**Apples and oranges**

SICs are reported by using two-, three-, and four-digit codes. For example, SIC 73 is business services; SIC 737 is comput-
ers; and SIC 7378 is computer maintenance and repair. Thus there are important methodological decisions to be made about the specificity of industry groupings. In its decisions about aggregating or disaggregating industry categories, the Commerce Department is inconsistent. In agriculture, mining, rubber, plastics and leather, pipeline and utilities, finance insurance, and real estate, the department merged substantially different industries into a single category. The construction industry, on the other hand, was not only broken down by building construction (SIC 15), heavy and highway construction (SIC 16), and special trades (SIC 17) but by nine geographical regions as well. There is no logical reason for combining some two-digit SIC codes and ignoring regional differences while separating others for regional analysis—except for the department’s desire to manufacture statistically significant results.

Since SDBs are more heavily represented in some four digit SICs than others, the decision to aggregate or disaggregate has practical consequences. If there is underutilization of SDBs in janitorial services, that should have no bearing on federal contracts for computer maintenance and repair. Since the data have not been broken down, there is no way to determine whether, if a disparity existed in SIC 73, a disparity would also exist in SIC 73 or SIC 7378.

As it happens, SIC 73 is not even an industry; it includes a hodgepodge of business services that are amalgamated merely for the convenience of census reporting. SIC 73 encompasses firms specializing in advertising, janitorial services, pest control, detective work, and computer services. The benchmark study reported that in SIC 73, SDBs comprised 47 percent of the total companies and 40.2 percent of the capacity competing for government contracting. Yet SDBs received “only” 26.4 percent of the contract dollars. On the basis of this disparity, SIC 73 was determined to be an “industry” where price-evaluation adjustments—the 10 percent rule—could be imposed. But, according to the Small Business Administration’s (SBA) website, within SIC 73, SDBs comprised only 2,749 of 44,258 small businesses—6 percent—in 1999. If large businesses and businesses not on the SBA list were added to the total, the percentage of SDBs declines even further. According to the
1992 Census of Service Industries, there were 306,551 establishments in SIC 73 that had employees.

The conclusion that small disadvantaged businesses hold 40.2 percent of federal contracting capacity within SIC 73 resulted from the benchmark study’s faulty methodology. For starters, the study considered 8(a) firms as available for all contracts in SIC 73—regardless of their specialties or whether they even offered bids for competitive contracts, or any contracts. In addition, the study did not consider the number of times a firm bid or the size of the contracts a firm bid upon, both of which affect the total dollars a firm is awarded. Since non-SDBs are larger than SDBs, it is plausible that for contracts without racial preferences, they would bid more often, and for larger contracts, than SDBs. Despite these and other egregious problems with the benchmark data, the Commerce Department regards the study’s conclusions as decisive for determining where bidding preferences should be applied.

Who is discriminating?

A properly done disparity analysis may reveal discrimination in contracting, but it rarely indicates the source of the discrimination. Identifying the source is essential to applying a narrowly tailored remedy. While the authors of the benchmark study state that its “methodology is designed to ensure that the price adjustments authorized by reforms are narrowly tailored to remedy discrimination,” they offer no explanation of how that discrimination occurred and by whom it was committed.

According to the Justice Department’s and SBA’s official testimony, they knew of no documented incidents of discrimination by a federal procurement officer in the last 10 years, let alone any pattern of discrimination. If federal procurement officers are discriminating in the awarding of contracts, sanctioning or retraining such officers, not using bidding preferences, would be the appropriate narrowly tailored remedy.

One theory the Commerce Department advanced is that the discrimination may occur somewhere in the private marketplace, making SDBs less competitive because of discrimination by lenders or suppliers. Aside from the fact that no study has identified patterns of private-sector discrimination in contracting with any
degree of specificity, such a theory is not plausible. To begin with, the regression adjustments in the benchmark study's statistics were intended to control for variation in firm capacities, so that differences in SDB and non-SDB capacity were already accounted for when the disparities were calculated. If there were other variables that might have affected the relative capacity of SDBs and non-SDBs, the study does not specify them. If firms of equal capacity receive unequal awards from federal procurement, that would indicate disparate treatment by federal procurement officers rather than by private-sector companies.

Another problem is that the benchmark study found uneven patterns of underutilization and overutilization for SDBs in several SICs that are inconsistent with theories of private discrimination. For example, SDBs were underutilized in SIC 34 (fabricated metal products) and overutilized in SIC 33 (primary metal industries). What theory of private-sector discrimination could explain such results? Finally, if underutilization of SDBs is a sign of discrimination in the private sector, what is overutilization of SDBs a sign of? Commerce Department officials had no explanation for this phenomenon.

More trouble ahead

The Commerce Department is proceeding with plans for a new benchmark study in the year 2000. Since the administration is paying private consulting firms to recruit 30,000 minority-owned businesses a year to seek SDB certification, SDB availability will surely increase. This will mean more "disparities," more political pressure for the expansion of bidding preferences, and more resentment at another unjust assault upon merit in our public policy.