U.S. House of Representatives Committee on Small Business

"U.S. GOVERNMENT CONTRACTING AND THE INDUSTRIAL BASE"

A Statement by:

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Chairman Chabot and Ranking member Velazquez, thank you for the opportunity to testify before you today about contracting and the industrial base. I am Andrew Hunter, Director of the Defense-Industrial Initiatives Group at the Center for Strategic and International Studies (CSIS). A major focus of my work at CSIS involves understanding the evolving partnership between the federal government and the industrial base. This partnership is critical to the successful execution of the more than $400 billion in federal contracting that occurs annually. As my title indicates, I have a particular focus on how this partnership is evolving between industry and the Department of Defense, however, CSIS performs in-depth analysis on data from the Federal Procurement Data System including contracting data from all federal agencies. While there are some important differences in trends for defense and non-defense contracting that I will highlight where appropriate, since defense contract obligations are roughly twice the total of non-defense contract obligations, overall trends in federal contracting tend to mirror those in defense contracting.

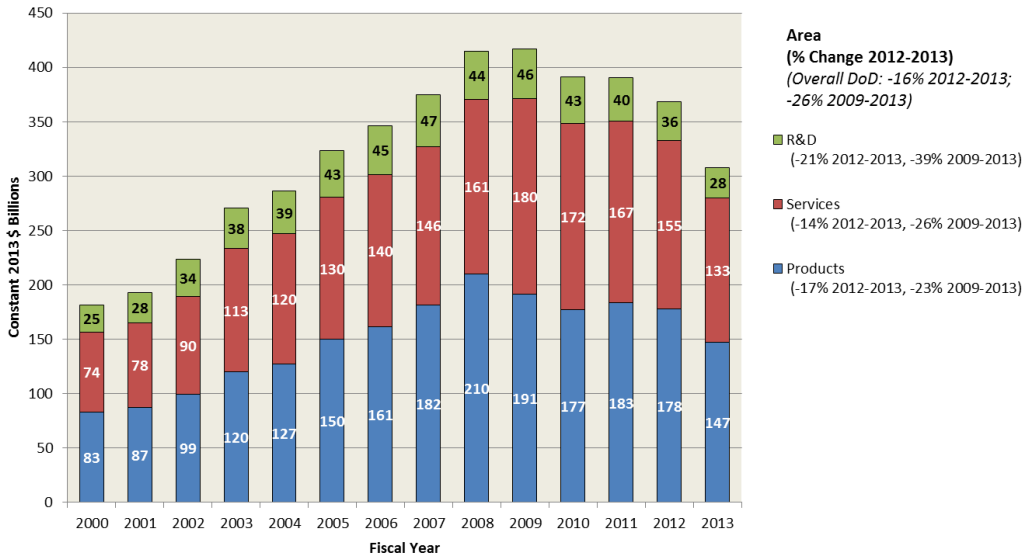
Contract obligations represent the overwhelming majority of the federal spending received by industry, and examining federal contracting data is essential to understanding many things currently happening in the industrial base. Today I intend to share with you some central insights arising from CSIS's analysis of contracting data to inform the committee's approach to the industrial base and particularly small businesses. To briefly summarize these insights, they are: 1) sequestration is currently the dominant force in federal contracting with repercussions that have been particularly severe for defense contracting; 2) federal contracting for R&D performed by industry is particularly challenged under sequestration potentially impacting the historical role that small business have played in technology innovation; 3) small business contracting is highly sensitive to changes in the overall federal contracting environment caused by sequestration and small businesses are likely to be significantly affected by a return to sequestration level spending levels in 2016; and 4) policies adopted by Congress are substantially reshaping the composition of small businesses participating in federal contracting. Separate from CSIS's data analysis, I would also like to emphasize my belief that the continuing, and in some cases increasing, complexity of the federal contracting process remains the most significant barrier to entry for firms of all sizes. It presents a particular obstacle for small businesses which are challenged to absorb the overhead required to successfully navigate this complexity. My testimony builds on the work of several of my colleagues at CSIS, especially Greg Sanders, Jesse Ellman, Rhys McCormick and Madison Riley, as well as my predecessor, David Berteau. Wherever possible, it has been updated to reflect data on 2014 contract obligations. CSIS does not take policy positions. All positions expressed to you as part of this testimony are my own.

The most apparent dynamic in federal contracting today is the effect of sequestration-level discretionary spending caps on contract obligations. It is worth noting that these caps have served to continue and accelerate a downward trend initiated by two other recent events: the sharp reduction in spending associated with the ending of the wars in Iraq and Afghanistan, which has primarily affected defense contract obligations, and the

completion of significant expenditures associated with the American Recovery and Reinvestment Act of 2009, better known as the stimulus bill, which has primarily affected non-defense contract obligations. As a result of these two factors that predate sequestration, defense contract obligations actually peaked in 2009 and have been declining since, while non-defense contract obligations peaked in 2010. In the case of DOD, sequestration significantly accelerated the pace of the decline in obligations in 2013. In the case of non-defense contract obligations, the first year of sequestration in 2013 continued the existing downward trend but contract obligations bounced back in 2014.

As illustrated in the figure below, defense contract obligations have declined 26% from their peak of $417 billion in the period from 2009 to 2013 in constant 2013 dollar terms. More than half of this decline, 16%, occurred in 2013 alone as result of the accelerated decline required by the mechanics of sequestration. Defense contract obligations for R&D purposes are considered separately from services in this analysis. R&D contract obligations have declined much more steeply, by 39% since 2009 and by 21% in 2013 alone.[1] CSIS is beginning to assess defense contract obligation data for 2014 which recently became available. Early analysis of this data show that the decline in defense contract obligations continued in 2014, falling by an additional nine%.

Figure 1: DoD Contract Obligations by Area, 2000-2013

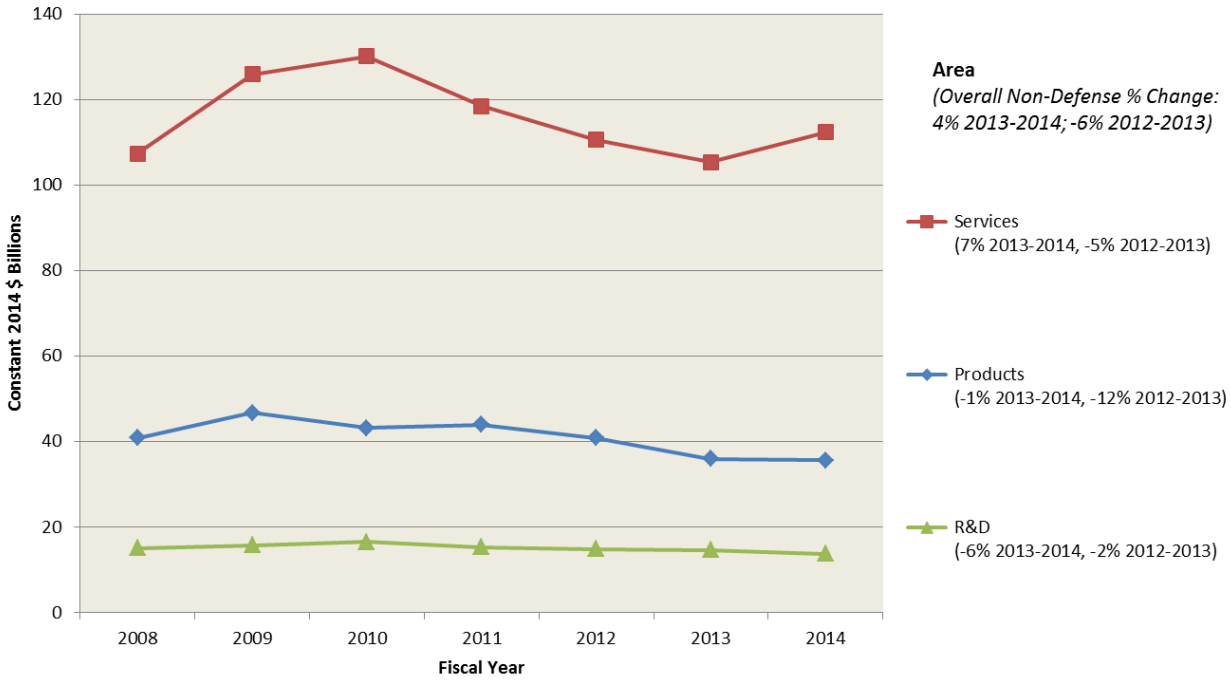


Source: FPDS and CSIS analysis.

[1] Figure 1 and the related analysis is derived from the CSIS Report "U.S. Department of Defense Contract Spending and the Industrial Base, 2000-2013" by David Berteau, Jesse Ellman, Gregory Sanders, and Rhys McCormick and can be found at http://csis.org/files/publication/140929_Ellman_DefenseContractSpending2013_Web.pdf. CSIS developed a measure of R&D contract obligations that reflects the vast majority of unclassified funding that actually makes it to industry for what is normally considered R&D purposes. For additional information about the CSIS contracting data analysis methodology, see https://csis.org/program/methodology.

Federal non-defense contract obligations have been trending steadily downwards since their peak of $190 billion in 2010, declining by six percent in each of the subsequent two years. Interestingly, overall federal non-defense contract obligations declined at that same rate, six percent, under sequestration in 2013, to $156 billion. The data show a small but broad-based rebound across the non-defense federal contracting agencies in FY2014, approaching FY2012 obligation levels in most cases. Most notably, while federal products contract obligations were nearly steady in 2014, and services contract obligations increased moderately, non-defense research and development (R&D) contract obligations declined three times as steeply in 2014 as they did in 2013. Coupled with the significant decline in defense R&D contract obligations in 2013, this data point lends credence to concerns that federal R&D contracting is being disproportionately impacted under sequestration.[2]

Figure 2: Non-Defense Contract Obligations by Area, 2008–2014



Source: FPDS; CSIS analysis

Non-defense services contracts, which had been declining steadily since their peak in 2010, declined by 5 percent under sequestration from 2012 to 2013, slightly less than the overall decline in non-defense contracts. Between 2013 and 2014, services contract obligations increased by seven percent, rising to $112 billion, exceeding the 2012 obligations level. Non-defense products contract obligations, which represent a much smaller share of overall contracting activity than in DoD, declined sharply under

[2] This analysis of non-defense contract obligations is taken directly from the work of Jesse Ellman in the CSIS Report "Sequestration Plus One: Early Indicators of the Federal Contracting Environment in the Era of Sequestration" which can be found at http://csis.org/publication/sequestration-plus-one-early-indicators-federal-contracting-environment-era-sequestratio.

sequestration (-12 percent), and failed to rebound in 2014 (-one percent). Non-defense R&D contract obligations, which declined by only two percent in 2013, fell by six percent in 2014. The overall picture for non-defense federal contracting agencies in 2014 shows a broad rebound for services contracts, a leveling off for products after a steep decline in 2013, and an acceleration of decline in R&D.

It is worth noting that the sharp reduction in contract obligations for R&D, occurring in both defense and non-defense contracting, presents specific concerns for the industrial base and for innovative small businesses. Federal investment in R&D has historically allowed small firms with limited financial resources to develop innovative technologies that larger firms may not be incentivized to pursue. The ongoing reductions in R&D put this important source of innovation at risk. The disproportionate reductions to defense R&D contract obligations are driven to a large extent by the mechanics of sequestration, which has largely excluded reductions in military pay and benefits and couldn't significantly address locked in costs in the defense budget such as civilian pay other than through furloughs. In addition, Congress' reluctance to fully support reductions in military compensation and force structure over the 2010-2013 period further constrained the areas where budgetary savings could be taken. These rigidities in several areas of the defense budget essentially transmitted the effects of the draw down and sequestration to areas such as R&D where they were more easily absorbed. The relatively uncertain nature of R&D means that R&D contracts are designed to be inherently flexible. Work can be relatively rapidly rescheduled to reflect the pace of technology development, or in the case of sequestration, to rapidly absorb unexpected budget reductions. Similar dynamics may be in play at non-defense agencies.

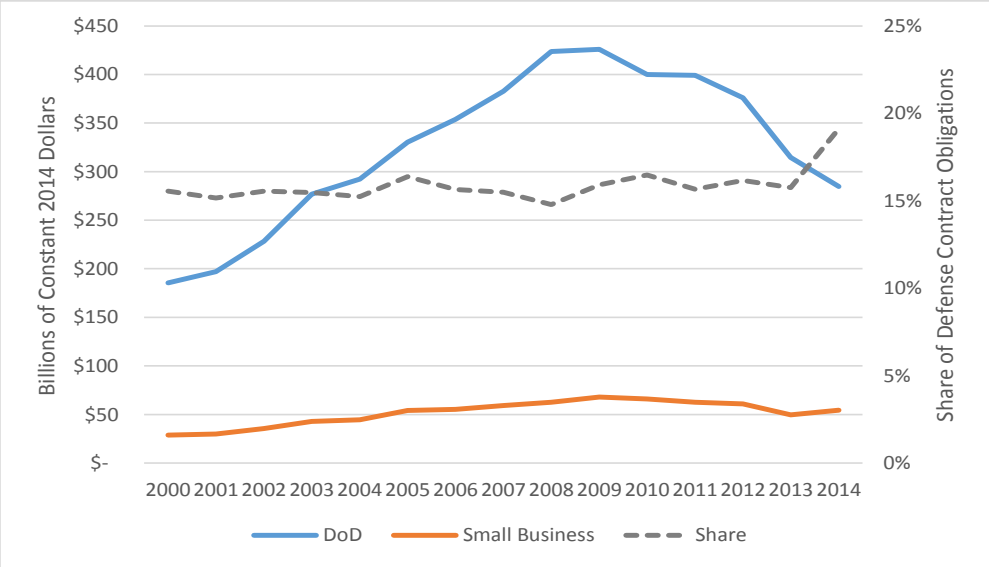
CSIS has done specific analysis on small business contracting with the Department of Defense to identify the effects of sequestration on small business, examine trends in competition, and explore areas of success and challenge for small business.[3] Given the demonstrated differences between defense and non-defense contracting trends, further analysis would be required to determine whether the trends in small business contracting with DoD also apply to non-defense contracting. However, given the volume of defense contracting, it is safe to conclude that these trends apply to the bulk of small business contracting.

In 2013, small business contracting with DoD declined 17%, roughly equivalent to the overall reduction of defense contract obligations of 16%. In 2014, however, after modest relief from sequestration provided by the Murray-Ryan budget agreement, small business contracting with DoD actually bounced back by 11% even as defense contract obligations overall declined by a further nine%. This surprising result, illustrated in Figure 3 below, explains how DoD was able to meet its small business contracting goals in 2014 for the first

[3] These issues will be examined in greater depth in a forthcoming CSIS paper building on work done by Madison Riley.

time in 8 years.[4] Given the highly stable share of contract obligations going to small businesses over the previous 13 years and based upon other data reviewed by CSIS that has indicated that sequestration in 2013 may have led to a shifting of contract obligations between 2013 and 2014, it is premature to conclude that the small business share of defense contract obligations is likely to continue at the level achieved in 2014. Rather, I believe that this data demonstrates that small business contracting has been highly reactive to changes in spending levels under sequestration and that a return to full sequestration spending levels in 2016 presents a significant risk of decline in small business contracting both in absolute terms and as a share of all contracts.

Figure 3: Small Business Contract Obligations as a Share of Defense Contract Obligations

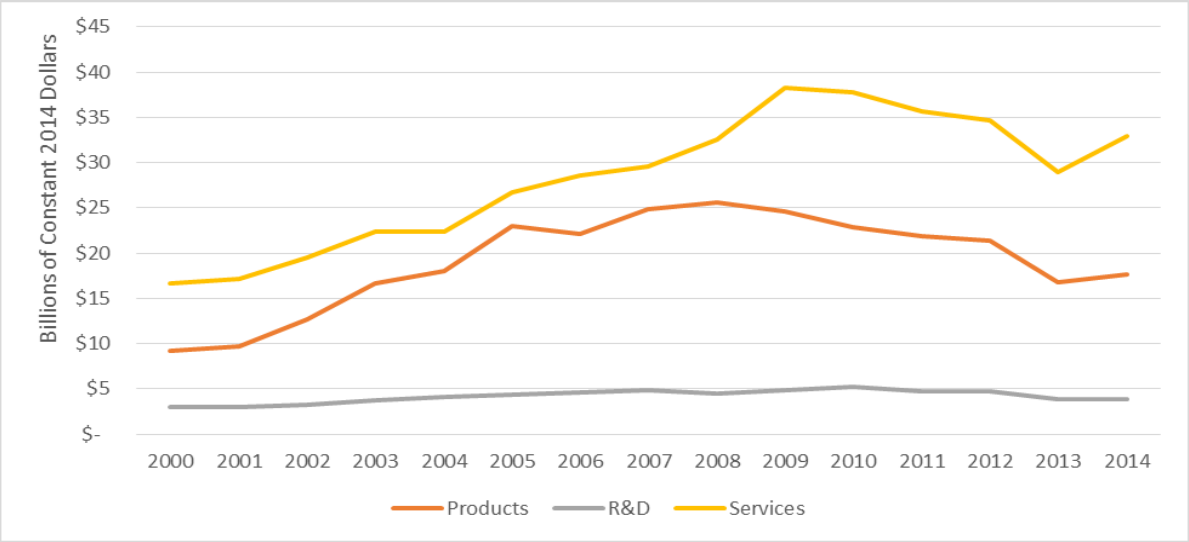


Source: CSIS analysis of FPDS data

Parsing the small business contracting data further between products, services, and R&D, as illustrated in Figure 4, shows that services contracts for small business rebounded by $3.9 billion dollars in 2014, 14 percent above 2013. Products rebounded by $972 million or 5.9 percent, but remains substantially below peak levels. R&D contracts did not significantly rebound in 2014. It is notable that R&D contract obligations for small business exhibited much less fluctuation over time than services or products, but has dropped $1.35 billion dollars below the 2010 peak. Again, this raises concerns about the ability of small businesses to continue to play their historical role as a source of defense innovation.

[4] Our analysis of small business contracting includes firms identified as small businesses in contract data and compares these firms' contract obligations with total contract obligations. This differs from the calculation of small business contracting for purposes of meeting Small Business Administration established contracting goals, which exclude certain contract obligations from the overall total. Also, in our analysis, we immediately remove companies from classification as a small business as soon as they are labeled as a subsidiary of a large business. We take no issue with the SBA's method for calculating compliance with its targets. The complexity of that calculation, however, is not necessary for CSIS to achieve its analytical objectives.

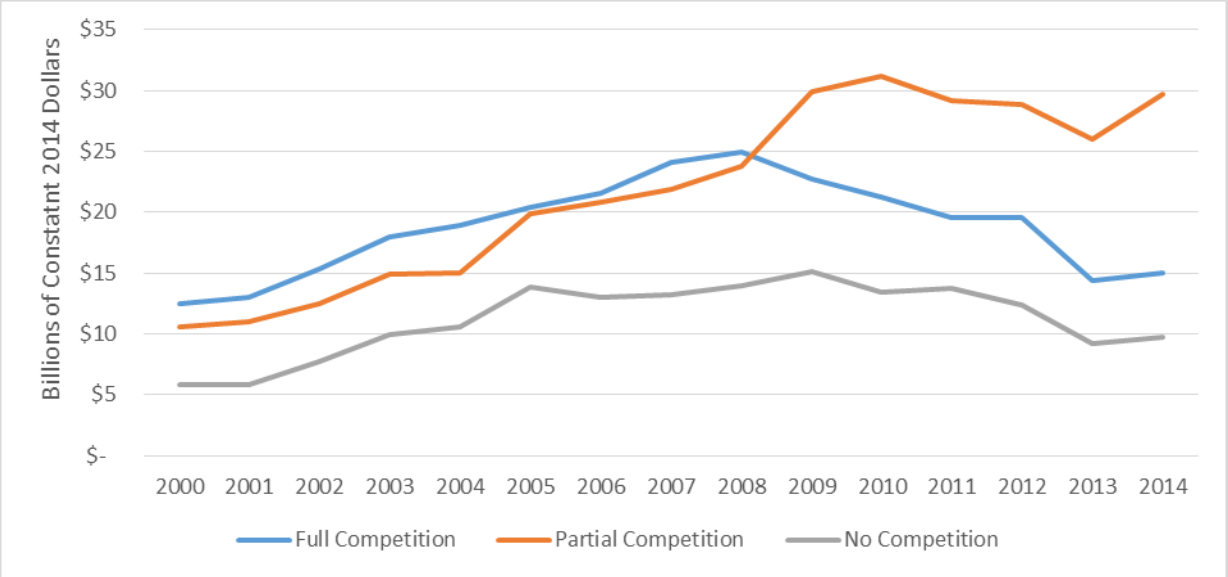
Figure 4: DoD Small Business Contract Obligations by Products, Services, and R&D



Source: CSIS analysis of FPDS data

The data on competition show that defense small business contracting is highly competitive, particularly by DoD standards, and that the share of small business contracts resulting from either full or partial competition has grown significantly over time, marked by particularly dramatic growth in partial competition.[5]

Figure 5: DoD Small Business Contract Obligations by Competition



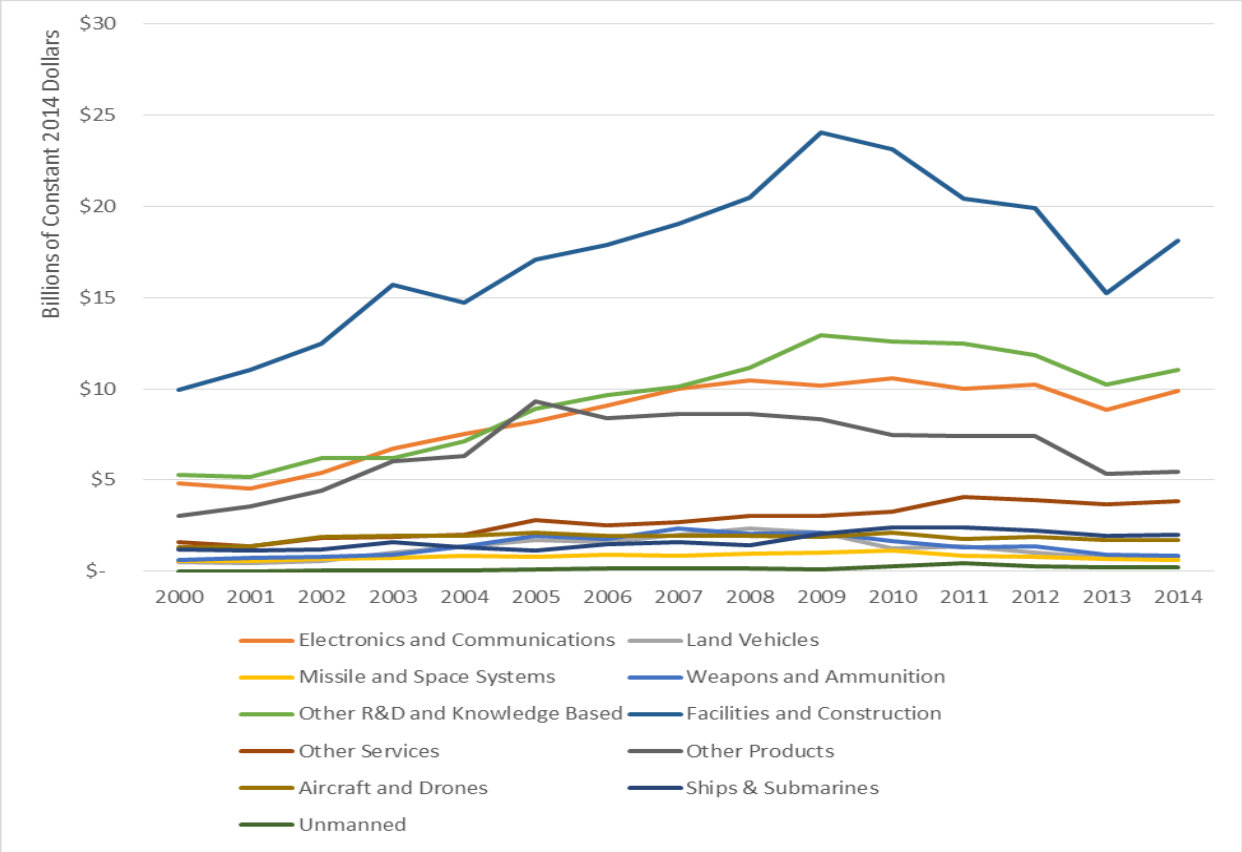
Source: CSIS analysis of FPDS data

Continuing past trends, the areas that had the greatest value of small business contract obligations were Facilities-Related Services and Construction (FRS&C),

[5] Partial competition represents competitive delivery orders, full and open competition with the exclusion of sources, and contracts competed under Simplified Acquisition Procedures. Full competition is defined as full and open competition only.

Professional Administrative and Management Support (PAMS), other R&D and Knowledge-Based Services, and Electronics & Communications (E&C). These areas are also among the ones that rebounded most strongly in 2014. By contrast, areas such as Missile and Space Systems, Weapons and Ammunition, Aircraft and Drones, and Unmanned have had little participation from small business and all continued to fall in 2014.[6]

Figure 6: DoD Small Business Contract Obligations by Platform Area

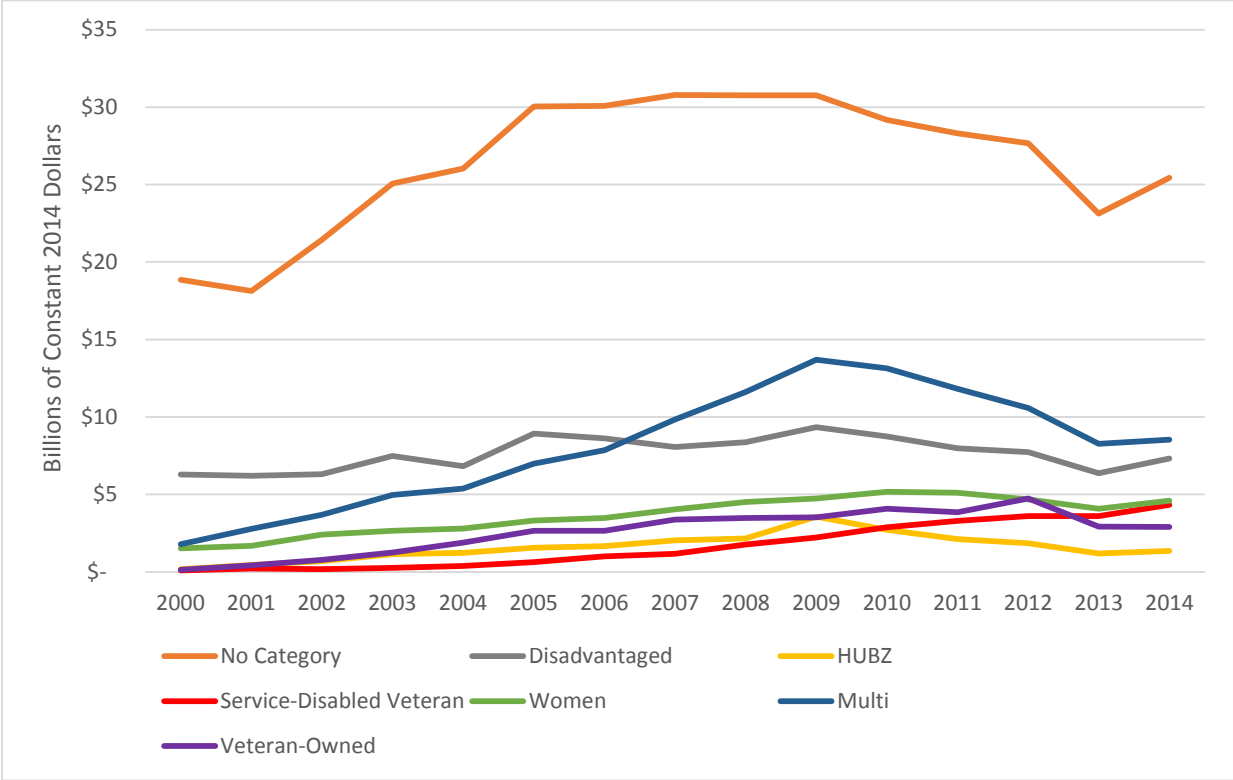


Source: CSIS analysis of FPDS data

An important shift has occurred in the composition of small businesses participating in federal contracting. CSIS analysis shows that the adoption of specific contracting goals for four targeted small business categories: small disadvantaged businesses, HUBZone businesses, women-owned businesses, and service-disabled veteran-owned businesses has had a significant impact. Since 2005 all of the growth in DoD small business contracting has happened within these targeted categories as shown in Figure 6 below. It does not currently appear that sequestration will alter this fundamental shift in small business contracting.

[6] As an aid to researchers seeking to reproduce or build on CSIS's work, our full Product Or Service Codes classifications are available through a GitHub repository (https://github.com/CSISdefense/Lookup-Tables).

Figure 6: DoD Small Business Contract Obligations by Category



Source: CSIS analysis of FPDS data

The challenges facing small business contracting under sequestration are substantial, but the 2014 contracting data show that small business can confront these challenges and compete and win if properly supported. I recommend that the committee continue to closely observe these issues, particularly the decline in R&D contract obligations which has not yet shown signs of abating. This worrisome trend is fundamentally incompatible with achieving national objectives. I also urge the committee to review the significant complexity in the federal contracting process confronted by small businesses as well as other firms and do what you can to combat it. I look forward to addressing your questions.