

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6515

To: Members, Subcommittee on Contracting and Workforce and Subcommittee on Economic Growth, Tax, and Capital Access
From: Committee Staff
Date: July 13, 2017
Re: Hearing: “The Puerto Rico Oversight, Management, and Economic Stability Act: State of Small Business Contracting”

On Thursday, July 13, 2017 at 10:00 a.m., the Committee on Small Business Subcommittee on Contracting and Workforce and Subcommittee on Economic Growth, Tax, and Capital Access will meet in Room 2360 of the Rayburn House Office Building. This hearing will examine the Government Accountability Office’s (GAO) report as mandated by the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) studying trends in small business contracting and the use of the Small Business Administration’s (SBA) contracting programs in Puerto Rico. This hearing will also examine challenges small businesses in Puerto Rico face in obtaining federal contracts.

I. Background on Puerto Rico’s Fiscal Crisis and PROMESA

The government of Puerto Rico faces severe a fiscal crisis as a result of long-standing budgetary, economic, and financial challenges¹. Since 2006, Puerto Rico has been spiraling into a recession resulting in a crushing \$123 billion dollar debt and pension obligations.² Emergency legislation in 2016 stated that the Puerto Rican government’s fiscal condition “is more dire than at any other point in its history.”³

In response to this increasingly difficult situation, Congress enacted The Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA)⁴ on June 30, 2016, which created an Oversight Board for Puerto Rico and established a process to restructure the island’s debts among other things. One of the ways PROMESA sought to stimulate small business investment and economic growth was through Section 412, which expanded the number of

¹ D. ANDREW AUSTIN, CONGRESSIONAL RESEARCH SERVICE, PUERTO RICO’S CURRENT FISCAL CHALLENGES 1 (2016)

² Mary W. Walsh, *How Puerto Rico Is Grappling With a Debt Crisis*, NEW YORK TIMES (May 16, 2017), <https://www.nytimes.com/interactive/2017/business/dealbook/puerto-rico-debt-bankruptcy.html>

³ Act 21 of 2016, the Puerto Rico Emergency Moratorium and Financial Rehabilitation Act, enacted on April 6, 2016.

⁴ Pub. L. No. 114-187, § 412, 130 Stat. 549, 595 (2016).

Historically Underutilized Business Zones (HUBZone) in Puerto Rico. Authorized in 1997,⁵ the HUBZone Program is charged with stimulating economic development by increasing employment and capital investment through the use of federal contracting preferences to small businesses operating in economically distressed areas.⁶ PROMESA also required the GAO in Section 408 to develop and submit a report assessing the application and utilization of federal small business contracting activities of the SBA in Puerto Rico.

II. Current Economic State and the State of Small Businesses in Puerto Rico

As of May 2017, the island is still in \$123 billion in debt,⁷ which is expected to top 107% of the island's gross domestic product by 2018⁸. The island's debt load is worth about \$34,000 per person, at approximately 3.5 million residents.⁹ Average incomes hover at one third of the mainland average and over half of Puerto Rico's families live below the poverty level.¹⁰

According to the Census Bureau, over 99% of the businesses in Puerto Rico are characterized as small by SBA's size standards.¹¹ Many small businesses surveyed by the Federal Reserve Bank of New York employ fewer than 10 employees, have annual revenues less than \$250,000, and 38% report annual revenues under \$50,000.¹² Cash flow and access to credit are the top challenges reported by small firms, with nearly 50% seeking financing.¹³ Nearly half of the firms requested training programs supporting growing sales, with training for federal contracts and sales to the federal government as their number one top-ranked training need.¹⁴

III. Small Business Federal Contracting in Puerto Rico

Total federal contracting prime dollar obligations to Puerto Rican small businesses ranged from \$404 million to \$1 billion during the past 10 fiscal years.¹⁵ The SBA manages several small business federal contracting programs in Puerto Rico and nationwide, including the 8(a) Business Development Program (8(a)), the HUBZone Program, Women-Owned Small Business (WOSB), and Service-Disabled Veteran-Owned Small Business (SDVOSB) programs. Small businesses receiving certifications through these programs become eligible for federal contracting preferences, such as sole-source awards (awards made to one firm without competition) and set-aside contracts (awards limited to a designated pool of competing firms).

⁵ The Program was officially established by SBA on March 22, 1999. HUBZone Act of 1997; Small Business Reauthorization Act of 1997, Pub. L. No. 105-135, § 601-07, 111 Stat. 2627-36 (1997).

⁶ S. REP. NO. 105-62, at 26 (1997), available at <https://www.congress.gov/congressional-report/105/senate-report/62>.

⁷ *Supra* note 2.

⁸ Nathaniel P. Flannery, *Will Puerto Rico Find A Way To Survive Its Debt Crisis?*, FORBES, June 1, 2017.

⁹ *Id.*

¹⁰ *Id.*

¹¹ GAO, PUERTO RICO: INFORMATION ON TRENDS AND CHALLENGES TO SMALL BUSINESS FEDERAL CONTRACTING I (GAO-17-550) (2017).

¹² Kausar Hamdani, et al., EVIDENCE FROM THE FEDERAL RESERVE BANK OF NEW YORK: PUERTO RICO SMALL BUSINESS SURVEY, FEDERAL RESERVE BANK OF NEW YORK 5 (2016)

¹³ *Id.*

¹⁴ *Id.* at 16.

¹⁵ *Supra* note 10.

The federal government has annual prime and subcontracting goals for these small business categories and an overall 23% target goal for contract dollars awarded to small businesses.

IV. GAO Report Findings

For contracts performed in Puerto Rico, the percentage awarded to small businesses was high compared to non-small businesses. In fiscal year 2016, small businesses in Puerto Rico received approximately 47% of federal prime contracting obligations for work performed on the island. This is notably higher than the 23% awarded to small businesses nationwide.¹⁶ Of contract obligations awarded to all small businesses for contracts performed in Puerto Rico, 81% went to small businesses physically located on the island in fiscal year 2016.¹⁷

- a. SBA's federal contracting programs are underutilized as a whole, but the 8(a) Program is the clear favorite of these programs.*

A substantial percentage of contracting obligations were awarded to small businesses in Puerto Rico without using SBA's federal contracting programs. Most were awarded either through full and open competition or other socioeconomic designations.¹⁸ The HUBZone and WOSB designations received a majority of obligations awarded to them irrespective of these designations. In contrast, the 8(a) and SDVOSB designations received a majority of the obligations awarded to them through those respective programs.¹⁹ However, agencies may count contracting dollars awarded to small businesses under more than one socioeconomic category; for instance, if an 8(a) contract is awarded to a business with both a HUBZone and 8(a) designation, the agency may count these dollars towards both the HUBZone and 8(a) small business contracting goals.²⁰

When the SBA's federal contracting programs were used to award contracts, the 8(a) program was the most highly utilized of all of SBA's contracting programs for the island and nationwide.²¹ Several reasons may account for this higher rate of use compared to other programs, including a higher degree of trust in 8(a) firms' competence, reduced restrictions on awarding sole-source contracts to 8(a) firms resulting in faster acquisitions, and the 8(a) program's business development assistance from SBA.²²

- b. Small business obligations in Puerto Rico are concentrated in three sectors from three of the biggest federal agency spenders*

In fiscal year 2016, federal prime contracting obligations awarded to small businesses in Puerto Rico concentrated in the manufacturing, construction, and professional services sectors.

¹⁶ *Id.* at 9.

¹⁷ *Id.* at 10.

¹⁸ *Id.* at 11.

¹⁹ *Id.* at 14.

²⁰ *Id.*

²¹ Even nationwide, the SBA's 8(a) contracting program was used at higher rates than all of SBA's other programs. *Id.* at 13.

²² *Id.*

This held true for contracts awarded through each of SBA’s federal contracting programs.²³ The Department of Defense (DOD), Department of Veterans Affairs (VA), and the General Services Administration (GSA) awarded the most prime contracting obligations to small businesses in Puerto Rico for contracts performed on the island; DOD spent the most at \$229 million (72%).²⁴

c. HUBZone Expansion in Puerto Rico did not have a major impact

Section 412 of PROMESA lifted a 20% statutory cap on HUBZone-qualified census tracts,²⁵ expanding the number of qualified areas from 260 to 776. However, only 30 new businesses submitted applications to the HUBZone program through March 2017. Of the 30, 16 were located in newly qualified census tracts. The number of certified HUBZone firms also barely increased; from the end of fiscal year 2015 to March 2017, only 17 firms became newly certified. Of the 17, six were located in newly qualified census tracts.²⁶

For all economic indicators assessed by GAO²⁷, previously designated census tracts (prior to enactment) showed elevated levels of distress compared to newly designated census tracts (after enactment), which in turn showed greater levels of distress than ineligible census tracts. For example, the average poverty rate in previously designated census tracts is 60.7%, for newly designated census tracts is 44.1%, and for ineligible census tracts is 20.2%.²⁸ GAO also found that the island, for all economic indicators across all census tracts, is still more economically distressed than the rest of the country.²⁹ For example, the average median household income for ineligible census tracts in Puerto Rico was \$39,805, compared to the national average of \$65,808.³⁰

SBA officials tried to speed up HUBZone application processing times for small businesses on the island; however, limitations in SBA’s online systems pose challenges to businesses seeking to learn if they are located in a HUBZone-designated area.³¹ SBA’s system was unable to process Puerto Rico’s unique formatting for addresses.³² However, SBA has created a new online mapping system that should provide a fix for this specific issue.

V. Challenges to Small Business Federal Contracting in Puerto Rico

In its report, GAO identified several challenges: increased use of contract bundling and consolidation, difficulty meeting contract requirements, lack of access to capital, and lack of

²³ *Id.* at 15.

²⁴ *Id.* at 16.

²⁵ 13 C.F.R. §126.103 and 26 U.S.C. §42(d)(5)(B)(ii)(I).

²⁶ *Id.* at 18.

²⁷ Poverty rate, unemployment rate, average median household income, average median housing value. *Id.* at 19.

²⁸ This is the 5-year average between the years 2011-2015. *Id.* at 19. This remains consistent with findings nationwide; a GAO report in 2015 showed that redesignated areas (those areas who become no longer HUBZone qualified for a period of 3 years following loss of the area designation) fare better than qualified areas, but are not as economically stable as unqualified areas. GAO, SMALL BUSINESS CONTRACTING: OPPORTUNITIES EXIST TO FURTHER IMPROVE HUBZONE OVERSIGHT 40-45 (GAO-15-234) (2015).

²⁹ *Supra* note 10, at 18-19.

³⁰ This is the 5-year average between the years 2011-2015. *Id.* at 19.

³¹ *Id.* at 25.

³² *Id.*

knowledge about the federal procurement process and available resources.³³ Puerto Rico's language barrier, geography and economic crisis may be exacerbating these challenges.³⁴

a. Contract bundling and consolidation impedes small business success

Contract bundling and consolidation decreases the number of small business contracting opportunities and reduces the small business workforce.³⁵ Contract bundling occurs when multiple, smaller contracts are grouped together to form a large contract that is typically unsuitable for award to a small business. Contract consolidation is defined similarly, the key difference being that it does not require a finding that the contract will not be suitable for award to a small business.³⁶ Smaller businesses are less likely to possess the capabilities to compete for these types of contracts, which require a broad scope of work. Businesses in Puerto Rico are likely to be even smaller than those on the mainland and therefore even less competitive in such situations.³⁷

b. Meeting procurement requirements is difficult as is keeping contract awards local

Meeting contract requirements pose unique challenges for small businesses in Puerto Rico, the lack of performance history in particular. Gaining relevant experience is difficult to acquire due to the limited opportunities available on the island.³⁸ Also, the way procurement requirements are drafted often do not match the experience of small construction firms on the island. For instance, even if the small business has a greater understanding of how the tropical climate or seismic risks impact the way a structure is built compared to small firms on the mainland, these factors are often not included in federal contracting requirements.³⁹

c. Lack of access to capital precludes additional financing and obtaining bonds

The convergence of these issues, coupled with a continuous lack of access to capital, has decreased the competitiveness of the island's small businesses. This situation has worsened due to the island's economic crisis. Bank failures in recent years impact small businesses' access to capital, as many banks are unwilling to extend credit to small businesses.⁴⁰ This lack of credit effects small businesses ability to obtain bonding. However, on April 24, 2017, SBA approved the first Puerto Rican surety company to participate in its Surety Bond Guarantee Program; this

³³ *Id.* at 19. These challenges are consistent with results found in a 2012 GAO report studying challenges small, including minority-owned, businesses nationwide face when seeking federal contracting opportunities. GAO, GOVERNMENT CONTRACTING: FEDERAL EFFORTS TO ASSIST SMALL MINORITY OWNED BUSINESSES 9-15 (GAO-12-873) (2012).

³⁴ *Supra* note 10, at 19.

³⁵ *Id.* at 20.

³⁶ *Bungling Bundling: How Contract Bundling and Consolidation Remain Challenges to Small Business Success, Hearing Before the H. Comm. on Small Bus.*, 113th Cong. (2013).

³⁷ *Supra* note 10, at 20.

³⁸ *Id.* at 21-22.

³⁹ *Id.*

⁴⁰ *Id.* at 22.

program provides qualifying surety companies a guarantee on a percentage of losses incurred on bonds issued to small businesses.⁴¹

d. Lack of knowledge about federal contracting and available SBA resources

Many Puerto Rican small businesses lack the infrastructure and knowledge to complete proposals in response to agency solicitations.⁴² When proposals are submitted, they are sometimes of low quality and do not meet agency-required guidelines.⁴³ Some small businesses are unaware of where to look for federal contracting opportunities. To alleviate this issue, SBA's Puerto Rico district office and small business advocacy groups hold regular training sessions and one-on-one appointments to help small firms to navigate the federal procurement process and write proposals.⁴⁴

Small businesses often do not know about SBA's contracting programs, where to look for this information, and how to complete the certification paperwork. SBA has conducted outreach on the island and teamed with the local government, nonprofits, and other associations to promote its small business programs and refer small businesses to SBA's resource partners. SBA's resource partners in Puerto Rico are: the Small Business and Technology Development Centers, Women's Business Centers, and volunteers serving through the SCORE program.⁴⁵

The island's geographic location makes it difficult for small businesses to market themselves and maintain a relationship with contracting officers who are generally located in headquarters on the mainland.⁴⁶ This is a particular challenge for the professional services industry in Puerto Rico, as contracting officers typically select small businesses nearby to agencies physical location.⁴⁷ SBA Procurement Center Representatives (PCRs) advocate for small businesses and work with federal agencies and small businesses to identify contracting opportunities.⁴⁸

VI. Conclusion

While SBA resources are available to small businesses located in Puerto Rico, significant challenges exist. These are the same challenges faced by small businesses nationwide, but are exacerbated by the island's current economic state and geographic location. Assessing small businesses nationwide in the same fashion may produce useful comparative data. Assessing strategies to increase the competitiveness of Puerto Rican small businesses in the federal contracting sphere may be helpful.

⁴¹ *Id.* at 23.

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ SBTDCs have offices in six municipalities, there are two WBCs, and 17 volunteers with SCORE. *Id.* at 24.

⁴⁶ *Id.* at 25-26.

⁴⁷ *Id.* at 26.

⁴⁸ *Id.* at 27.