University of Kentucky

Gatton College of Business and Economics

Institute for the Study of Free Enterprise

Study analyzes the extent to which subcontracting requirements for the utilization of historically disadvantaged firms affects the costs of government procurement

- **In 2013, 26.1 percent of government spending and over 10 percent of US GDP was spent on public procurement**
- **This same year 23.4 percent of procurement spending was paid to small businesses, and 8.61 percent of procurement spending went to small businesses owned by ethnic minorities or women**
- **These levels of spending are driven by subcontracting requirements that mandate certain portions of each project are spent on subcontractors owned by historically disadvantaged groups**

Government spending and in particular, public procurement, is closely scrutinized due to the immense sums that are spent by federal, state, and local governments each year. Ben Rosa, Assistant Professor of Economics at the University of Kentucky and ISFE Affiliate, has recently authored a study that analyzes how public procurement costs are affected by laws aimed at reducing inequities through mandated minimum levels of subcontracting to firms owned by historically disadvantaged groups on state projects in New Mexico.

Utilizing structural modeling methods, Rosa finds that subcontracting requirements in New Mexico increased revenue for subcontractors owned or controlled by members of historically disadvantaged groups by 13.8 percent, while only increasing public procurement costs by 0.2 percent. He finds that markups on bids sent in by prime contractors decreased since prime contractors only mark up their bids for the portion of the work they actually perform, not

the work performed by subcontractors, which may have partially offset any increase in costs from the subcontracting requirements.

In the paper, a counterfactual analysis asks whether or not a quota or a subsidy would be more effective than the subcontracting requirement currently in law. Rosa finds that quotas, while more successful in increasing the amount of work given to subcontractors from historically disadvantaged backgrounds, are not effective at constraining costs. Alternatively, he finds that subsidies effectively make these subcontractors less costly and induce substitution from costly to less costly subcontractors. This results in increasing the amount of work given to this set of subcontractors while also reducing the price of bids.

Rosa notes, “the subcontracting policy requires that prime contractors select subcontractors from a common pool of preferred firms, leading to a shared component in their project costs. Theoretically, this shared cost component reduces markups, and the reduction in markups can be sufficiently high to mitigate cost increases from using more costly subcontractors.”

He continues, “although my analysis focuses on the DBE program in New Mexico, the markup reduction from a common subcontractor pool is not unique to DBEs and can be applied to other settings where firms are required to utilize a common pool of approved subcontractors. A common subcontractor pool can potentially arise for different classes of disadvantaged firms, such as small businesses and veteran-owned firms, and even firms that are not disadvantaged.”