

STRATEGIC SOURCING: SAVINGS VS. IMPACTS ON SMALL AND DISABLED VETERAN BUSINESSES

Eight years after California embarked on an initiative to leverage the state's purchasing power through large, statewide contracts for certain goods and services, the state no longer knows how much it continues to save from such contracts.

Some small and disabled veteran business owners, however, say they have paid a steep price for the wave of contract consolidation the state launched in 2004, ironically as the federal government was moving in the opposite direction. Small businesses that have been dependable state contractors for years say they have been forced to lay off employees and, in some cases, to close.

The so-called Strategic Sourcing Initiative bundled smaller contracts that in many cases had been issued by individual departments and agencies. In the process, it reduced contract opportunities for small businesses and disabled veteran business enterprises, or DVBES. Small business owners have told the committee that many of the contracts they bid on in the past simply no longer exist.

The Department of General Services awarded an initial round of 33 strategically sourced contracts that produced \$160 million in identifiable savings over 29 months. DGS has since rebid or extended many of these contracts, although it has not entered into any new strategically sourced contracts since 2006.

Instead, DGS continues to issue statewide contracts through what it describes as traditional contracting methods. For these contracts, DGS does not do a comprehensive analysis of past purchasing data, which was used to establish a baseline for strategically sourced contracts – a baseline from which the state could project and verify savings. The department also no longer tracks savings from statewide contracts.

Trade-off between conflicting state goals. In a July 2010 report, the state auditor noted that strategically sourced contracts present a trade-off between conflicting state goals – the responsibility to be as efficient as possible and the desire to support small businesses, which represent 97 percent of the state's private employers.

Small businesses – which include 85 percent of California's DVBES – are considered a cornerstone of the economy and a likely source of many of the new jobs that would sustain and drive a recovery from the current recession. In addition, state law requires the owners of certified small businesses and DVBES to be domiciled in California, while out-of-state firms have won some of the recent statewide contracts.

Impact on small businesses unclear. The state auditor concluded that the impact of strategic sourcing on the number of small businesses and DVBES contracting with the state is unknown.

Data that DGS collects on the annual volume of state contracting with small and disabled veteran businesses is often incomplete or, for other reasons, unreliable, the auditor found.

General Services also did not document the level of state contracting with small and disabled veteran businesses before strategic sourcing began.

The most recent DGS report, for fiscal year 2008-09, shows that small businesses received \$2.4 billion, or nearly 27 percent of almost \$9 billion in contracts issued by all reporting agencies for goods, services and construction. That volume exceeds that state's 25 percent target for contracting with small businesses. But that report is now 2 years old and relies on the same data the auditor flagged as incomplete and unreliable.

The same report shows that DVBEs received nearly \$190 million, or 2.96 percent of \$6.4 billion in similar contracts issued by reporting state departments. That volume fell just short of the 3 percent state target for contracting with disabled veteran businesses. The 2009-10 report, due to the Legislature last fall, has not yet been completed.

Federal government moving in opposite direction. As California embarked on strategic sourcing, the federal government was scaling back a similar push known simply as contract bundling. The federal shift, initiated by former President George W. Bush's administration, was precipitated at least in part by concerns that contract bundling was squeezing out competition and innovation, and leading to higher prices and reduced employment over time.

"Not only are substantially fewer small businesses receiving federal contracts, but the federal government is suffering from a reduced supplier base," Angela Styles of the Office of Management and Budget wrote in an October 2002 letter to President Bush. "American small businesses bring innovation, creativity, competition and lower costs to the federal table. When these businesses are excluded from federal opportunities through contract bundling, our agencies, small businesses and the taxpayers lose."

Level of enforcement questioned. In addition to fewer contract opportunities, California's small businesses and DVBEs have complained for nearly a decade – the state auditor issued a report on the subject as far back as 2002 – about examples of apparent abuse and manipulation of the state's procurement preferences. They believe a dearth of enforcement has allowed unscrupulous competitors to secure state contracts that otherwise would have gone to legitimate small or disabled veteran businesses.

State law requires certified small and disabled veteran businesses to perform a "commercially useful function" in any state contract. But the so-called "CUF law" was written to cover the range of state contracts and appears to be open to broad interpretation. It also failed to assign responsibility for enforcement.

General Services, in developing regulations to carry out the law, assigned the enforcement responsibility largely to individual departments and agencies that make most of the purchases.

The auditor, however, suggested that DGS, as the state's umbrella procurement agency, should at least monitor the large, statewide contracts for compliance with the law.

Although state departments and agencies are required to report alleged violations to DGS, DGS officials said the department compiles very little enforcement data and receives few complaints about CUF violations. Over the past eight years, DGS has suspended just two small businesses and 16 DVBEs for CUF violations.

A small business/DVBE specialist with one major state agency, Caltrans, told the committee that that agency alone typically refers to DGS as many as 20 small or disabled veteran businesses a year that are no longer allowed to bid on Caltrans contracts because of alleged CUF violations. Despite the referrals, those businesses often are allowed to continue doing other types of business with the state, according to Caltrans.

In an effort to increase CUF enforcement and discourage fraud and abuse, the Legislature last year passed and Gov. Schwarzenegger signed AB 177 (Ira Ruskin/V. Manuel Perez, Chapter 342), which increased potential fines and the length of time violators could be banished from doing business with the state. The bill also authorized DGS and other state agencies to collect costs of such investigations from violators.

Direct purchase discretion narrowed. Small businesses and DVBEs say their ability to contract with the state also has been hampered by restrictions General Services has placed on so-called "off ramps," provisions that allow state agencies to purchase goods and services directly from small or disabled veteran businesses even though those goods and services are covered under an existing statewide contract.

California Government Code section 14838.5 authorizes "off ramp" purchases of up to \$250,000, "as long as the agency obtains price quotations from two or more certified small businesses, including microbusinesses, or from two or more (DVBEs)."

Off ramp rules recently issued for a new statewide office products contract contain two additional requirements. Departments must document that goods being purchased are:

- "Equivalent" to goods available under a statewide contract, "including product description, functional requirements and manufacturer warranties as provided in the statewide contract."
- "Equal to or less expensive than the pricing offered from the statewide contract for the same products based on the total order value."

Small businesses say the additional restrictions have made it much more difficult to retain longstanding clients and participate in multimillion-dollar statewide contracts.

BACKGROUND ON STRATEGIC SOURCING AND CERTIFIED SMALL AND DISABLED VETERAN BUSINESSES

The Strategic Sourcing Initiative

As part of the effort to close a large and chronic budget deficit, former Gov. Arnold Schwarzenegger's administration in 2004 launched a Strategic Sourcing Initiative designed to save money by leveraging the state's purchasing power through large statewide contracts. Those contracts consolidated many smaller contracts that had been awarded by state departments and agencies.

The Strategic Sourcing Initiative enlisted a private contractor, CGI-American Management Systems, to identify through an analysis of past purchasing data those goods and services that state agencies purchased most frequently. Based on that systematic analysis, CGI also projected the savings that could be expected from bundling those contracts.

Based on CGI's recommendations, the Department of General Services (DGS) awarded 33 statewide contracts for 10 types of goods – office supplies and equipment, personal computers, wireless equipment and services, pharmaceuticals and motor vehicles, among others – between February 2005 and July 2006.

Those contracts yielded \$160 million in savings over a 29-month period – a \$96.6 million average annual savings, according to the state auditor. That represented a savings rate of 18 percent on the nearly \$533 million the state had spent annually on average on those goods.

DGS has since rebid or extended many of these contracts, although it has not entered into any new strategically sourced contracts since mid-2006. The department continues to issue large, statewide contracts for goods and services through traditional contracting methods. For those contracts, DGS does not do an analysis of past purchasing data, which was used to set up and demonstrate the value – as a baseline for projected savings – of strategic sourcing.

Certified Small Businesses

To qualify for certification, a small business must:

- Have 100 or fewer employees with average annual gross receipts of \$14 million or less over the last three tax years.
- Be independently owned and operated.
- Not be dominant in a field of operation.
- Have its principal office in California.
- Have owners (officers, if a corporation) domiciled in California.

Upon meeting the eligibility requirements, certified small business are entitled to a 5% bid preference on applicable state solicitations. The state also has set as a goal the use of small businesses in at least 25 percent of annual contract dollars.

Disabled Veteran Business Enterprises (DVBEs)

For DVBE certification purposes, a "disabled veteran" must be California resident and a veteran of the U.S. military with a service-connected disability of at least 10 percent.

To be certified as a DVBE, a business must be:

- At least 51% owned by one or more disabled veterans.
- Managed and controlled by one or more disabled veterans.

The state's goal is to use DVBEs for at least 3 percent of the state's annual contract dollars.

The "commercially useful function" or CUF law

Enacted in 2003 in response to abuse of purchasing preferences for DVBEs, the statute widely known as California's CUF law is designed to thwart those who might serve as "pass-throughs" or agents for larger companies. The law requires certified small businesses and DVBEs to do all of the following:

- Be responsible for executing a distinct element of the work of the contract.
- Actually perform work, manage or supervise the work involved.
- Perform work that is normal for its business services and functions.
- Not further subcontract a portion of the work that is greater than that expected to be subcontracted by normal industry standards.

Off Ramps

Off ramps are provisions in state law and contracts that allow state agencies and departments to purchase goods or services from certified small businesses or disabled veterans business enterprises (DVBEs), even though those goods or services are covered by a mandatory, or other statewide contract.

Section 14838.5 of the California Government Code says state agencies may award contracts of up to \$250,000 to certified small businesses or DVBEs for goods, services or information technology as long as the agency obtains price quotes from two or more certified small businesses or DVBEs.

Fast Facts about California Small Business

Compiled by: Assembly Committee on Jobs, Economic Development, and the Economy
V. Manuel Perez, Chair

Small businesses play an essential role in California's regional economies and industry clusters, generating an annual payroll of \$6.6 billion in 2008.ⁱ Definitions of small business often vary by program and industry. Sometimes a small business is defined by number of employees and in other cases defined by gross receipts and/or other financial data.

California Economy

- California's gross domestic product (GDP) was \$1.9 trillion in 2009, as compared to the United States with an estimated GDP of \$14.3 trillion.ⁱⁱ
- California's GDP ranked it as the 8th largest economy in the world in 2009.ⁱⁱⁱ
- California's real GDP increased by 1.3% in 2008. By comparison, real GDP growth in the United States is 0.7%.^{iv} It is estimated, however, that California's real GDP will have decreased by 1.7% in 2009.^v
- California had a labor force of 18.08 million people^{vi} with an unemployment rate of 11.9% in April 2011.^{vii}
- California has nine economic regions: Northern California, Northern Sacramento Valley, Greater Sacramento, Bay Area, Central Coast, San Joaquin Valley, Central Sierra, Southern California, and Southern Border.¹
- California ranks 4th among 50 states in the Milken Institute's State Science and Technology Index. The index ranks states based on research and development dollars, number of patents issued, venture capital investment, and business starts.^{viii}
- California ranks 1st among 50 states for patents issued in 2010 when 30,080 total patents were granted.^{ix}
- California ranks 1st in start-ups and 1st in new branches in high-tech manufacturing in 2008.^x
- California ranks 4th highest among 50 states as having the heaviest business tax burden. The 2008 State Business Tax Climate Index, prepared by the Tax Foundation, is based on a composite score of the state taxes related to income, sales, unemployment, and property. California ranked heaviest in the nation for its individual income tax system and 8th heaviest in its sales tax system.^{xi}

Small Business Facts in the United States

- In 2008, there are 5.9 million small businesses (employees 1-99) in the United States, constituting 98.3% of all private firms with employees.^{xii}
- California, New York and Florida had the highest percentage of small businesses (employees 1-99), consisting of 97.4% of all private firms in 2008.^{xiii}
- Small businesses (employees 1-99) in the United States employed 44.4 million employees, 35.7% of all private-sector employees in 2008.^{xiv}
- The construction sector had the highest number of small businesses (employees 1-99) composed of 98.9% of all private firms in 2008.^{xv}

Small Business Facts in California

- Among all private sector employers in California in 2008, 717,000 (98.2%) are small employers (employees 1-99)^{xvi}

- Small employers (employees 1-99) employ 39% of the state's all private-sector paid employees and paid 32.1% of the state's all private sector payrolls in 2008.^{xvii}
- Change by years (from year 1991 to 2008):
 - The number of small businesses (employees 1-99) increased from 625,080 to 717,133.^{xviii}
 - The number of paid employees from small businesses (employees 1-99) increased from 4.5 million to 6.7. million.^{xix}
- Below is a table of business growth by employee size from 2002 to 2008.^{xx}

Business Growth by Employee Size						
No. of Employees	1-4	5-9	10-19	20-99	100-499	500+
Growth of Jobs	10.15%	6.01%	2.5%	0.87 %	2.7%	9.89%
Growth of Firms	29.25%	5.82%	2.48%	1.01%	3.09%	5.45%

Source: California Economic Profile: A Statewide Overview & Regional Analysis

- Small business by industry sectors (employing 1-99) :
 - The Professional, Scientific & Technical Services sector had the highest percentage of small businesses in 2008, consisting of 16.3%.^{xxi}
 - The Real Estate & Rental & Leasing sector, had the second highest percentage of small businesses, consisting of 98.0% of all the firms in 2008.^{xxii}
 - The Accommodation & Food Services sector has the largest number of workers employed by a small business, consisting of 1.4 million employees in 2008.^{xxiii}

Businesses Owned and Operated by a Single Person

- There were 21.3 million businesses owned and operated by a single person in the United States in 2008, with total receipts of \$ 970.8 million.^{xxiv}
- For California, there were 2.8 million businesses without employees, with total receipts of \$137.5 million in 2008.^{xxv}
- The Professional, Scientific, and Technical Services sector had the largest number of businesses without employees in both the United States (3.0 million) and in California (475,000) in 2008.^{xxvi}

Micro Business in California

- There were 4.2 million Californians employed by microbusiness in 2007.^{xxvii}
- There are 3 million microenterprises in California operating as sole proprietorships.^{xxviii}
- In 2009, members of the California Association for Microenterprise Opportunity assisted 21,000 business, generating \$1.5 billion in economic opportunity. CAMEOs' research indicates that microenterprises have a much greater impact on the local community than that of a national chain store, having a multiplier effect of twice that of a national chain.^{xxix}

Other Features About Small Businesses in California

- 1.6 million small businesses (employees 1-499) were male-owned in 2002, twice those of women-owned, and a 20.4% increase from 1997^{xxx}.

- 430,000 small businesses (employees 1-499) were Hispanic-owned, 370,000 were Asian-owned, 110,000 were African American-owned, 38,000 were native American/Alaskan-owned and 7,000 were Hawaiian and Pacific Islander-owned in 2002^{xxx}.
- Below is a table of net job change by size of employees from 2002 to 2006 in the non-farm sectors.^{xxxii}

Net Job Change by Firm Size 2004-2007 (Nonfarm)								
	Total Net New Jobs	1-4	5-9	10-19	20-99	100-499	<500	500+
2006-2007	-60,110	125,188	19,767	-1,602	-46,761	-74,104	-82,598	22,488
2005-2006	451,231	140,266	48,578	54,001	88,089	39,742	370,676	80,555
2004-2005	127,469	128,749	25,006	6,843	-32,781	-16,130	111,687	15,782

Source: U.S. Dept. of Commerce, Bureau of Census

- ⁱ <http://www.census.gov/epcd/susb/2008/ca/CA--.HTM>; accessed 6-1-2011
- ⁱⁱ <http://www.bea.gov/region/gsp> Accessed 2-25-09
- ⁱⁱⁱ <http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf> Accessed 2-25-09
- ^{iv} <http://www.sba.gov/advo/research/profiles/> accessed 6-1-2011
- ^v <http://forecast.pacific.edu/cametroforecast/Executive-Summary-Dec08.pdf> accessed 6-1-2011
- ^{vi} http://www.edd.ca.gov/About_EDD/pdf/urate200902.pdf Accessed 3-3-2009
- ^{vii} <http://www.bls.gov/news.release/laus.nr0.htm> Accessed 3-3-2009
- ^{viii} <http://www.milkeninstitute.org/tech/tech.taf> Accessed 2-24-09
- ^{ix} http://www.uspto.gov/web/offices/ac/ido/oeip/taf/cst_all.pdf Accessed 2-14-09
- ^x http://www.gcx-online.com/gcx/article.asp?magarticle_id=601 Accessed 2-14-09
- ^{xi} http://www.taxfoundation.org/files/bp59_es.pdf ; accessed 6-1-2011
- ^{xii} <http://www.census.gov/epcd/susb/2008/us/US--.HTM>; accessed 6-1-2011
- ^{xiii} <http://www.census.gov/epcd/susb/2008/us/US--.HTM> accessed 6-1-2011
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- ^{xvi} <http://www.census.gov/epcd/susb/2008/ca/CA--.HTM> accessed 6-1-2011
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- ^{xviii} <http://www.census.gov/epcd/susb/2008/ca/CA--.HTM> accessed 6-1-2011
- ^{xix} <http://www.census.gov/epcd/susb/2008/ca/CA--.HTM> accessed 6-1-2011
- ^{xx} http://www.labor.ca.gov/panel/pdf/2008_California_Economic_Profile.pdf accessed 6-1-2011
- ^{xxi} <http://www.census.gov/epcd/susb/2008/ca/CA--.HTM> accessed 6-1-2011
- ^{xxii} <http://www.census.gov/epcd/susb/2008/ca/CA--.HTM> accessed 6-1-2011
- ^{xxiii} <http://www.census.gov/epcd/susb/2008/ca/CA--.HTM> accessed 6-1-2011
- ^{xxiv} <http://www.census.gov/epcd/nonemployer/2008/us/US000.HTM> Accessed 2-24-2009
- ^{xxv} <http://www.census.gov/epcd/nonemployer/2008/ca/CA000.HTM> Accessed 2-24-2009
- ^{xxvi} <http://www.census.gov/epcd/nonemployer/2008/us/US000.HTM> Accessed 2-24-2009
- ^{xxvii} <http://www.microbiz.org/wp-content/uploads/2011/04/2011> ; accessed 6-1-2011
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