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Pennsylvania Senate State Government Committee

Testimony of

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Pennsylvania Strategic Sourcing Sacrifices Small Business on the Alter of Savings

Strategic Sourcing is an “Unnecessary Self-Inflicted Wound”

Introduction:

Good morning, Chairman Folmer, Minority Chair Williams, and members of the Committee. Thank you for inviting me to share my **Bornstein & Song Research on the Pennsylvania Strategic Sourcing Initiative (PSSI)** and the **need for a Cost-Benefit Analysis** with special attention to the Economic and Social Costs of Job Loss.

Following my Testimony, please note the **Five Questions** Addressed to the **Department of General Services**.

My name is Samuel D. Bornstein. For the **past 37 years**, I have been a Professor of Accounting and Taxation, as well as a CPA and Consultant in public practice. This combination of experience as an **educator and practitioner** has given me an interesting **perspective and insight** into **research on Small Business Issues**, which I have been conducting with my partner, Jung I. Song, CPA, of Bornstein and Song CPAs & Consultants, **since year 2000**.

Strategic Sourcing has been our **research focus since 2005**, when the Federal Government introduced the Federal Strategic Sourcing Initiative (FSSI). Bornstein & Song FSSI Research intensified in 2010 as the Federal Government implemented its **first FSSI for Office Supplies** which awarded contracts to only **15** federal contractors out of the **569** who were eligible.

- **The negative impact of this FSSI is best evidenced by the 100+ Testimonials from **Federal Office Supplies Vendors**, which appears on our **Bornstein & Song FSSI Research Website** at www.bornsteinsongFSSI.com .**
Their compelling stories express how the **FSSI has damaged their businesses and their lives.**
- Our **Bornstein & Song FSSI National Surveys** determined that this Strategic Sourcing program had a significant negative impact on Small Business and the economy. It was clear that a **Cost-Benefit Analysis** was necessary. **But**, it was ignored.

How Can You Manage, If You Don't Measure?

Recognizing that a **Cost-Benefit Analysis is a Best Practice in management decision-making**, the lack thereof would prevent the proper vetting of this procurement program and thereby fail to determine whether Strategic Sourcing was doing **more harm than good**.

- **Bornstein & Song** has been driven by the concern that Strategic Sourcing has been detrimental to Small Business and the economy, based upon the basic precept of Strategic Sourcing which awards government contracts **to a select few** while **displacing** the vast majority of **small businesses** and resulting in **significant job losses**.

This aspect of Strategic Sourcing is most **troubling** and has been the chief motivating factor for Bornstein & Song to push for a **Cost-Benefit Analysis** which would bring to light the **true impact of Strategic Sourcing** on small business and the economy as a whole.

Strategic Sourcing May be Hazardous to Small Business and the Pennsylvania Economy: Lessons to be learned from California

My Testimony is intended to **highlight a significant weakness** of the Pennsylvania Strategic Sourcing Initiative (PSSI) program, which is highly relevant as this Committee addresses its implementation which has been downgraded and terminated. **The question is whether to reinstate this program at the present time.**

The Commonwealth of Pennsylvania is to be congratulated for being the 2nd State to have conducted an **Audit of their Strategic Sourcing Program**, when it authorized the evaluation of the PSSI in **Senate Resolution 2007-41** dated April 17, 2007.

California previously evaluated its **Strategic Sourcing Initiative (CSSI)** through an **Audit** conducted by the State Auditor, as well as a **Hearing held on June 8, 2011** by the State Assembly Committee on Accountability and Administrative Review. The Committee Hearing was to determine whether the CSSI should be reinstated after its initial run in February 2005 to June 2007.

- **I was invited to Testify** based upon my **Bornstein & Song Research** on the Impact of Strategic Sourcing on Small Business. My Testimony quantified the Costs of the program which DGS failed to address. These Costs include the **Economic & Social Costs of Job Loss** along with the **Social Safety Net Costs** which would be borne by the State. The research clearly showed the need for a Cost-Benefit Analysis to properly vet the program.
- **As a result of the Hearing**, the Committee expressed concern for the impact on small business and issued recommendations which **required that the DGS submit a Cost-Benefit Analysis** before the Committee would consider a reinstatement of the CSSI. Since DGS was unable to submit the Cost-Benefit Analysis, **California terminated its Strategic Sourcing program.**

It should be noted that while the CSSI had **accrued net savings of \$160 million** from February 2005 to June 2007, nevertheless California decided **not to renew** the program.

Pennsylvania Strategic Sourcing Mirrors California Strategic Sourcing

The **California decision should be considered** as Pennsylvania addresses its Strategic Sourcing program. While the proponents of Strategic Sourcing tout the **Savings**, there is a need for **an evaluation** of the **Costs** of the program. **Bornstein & Song Research** has emphasized the **need to quantify** the impact on Small Business and the State Economy as a result of the **displacement of the small business industrial base and the resulting job losses.** A Cost-Benefit Analysis would accomplish this.

The 2008 Audit of the Pennsylvania Strategic Sourcing Program

The fact that small businesses have been **displaced** by the Pennsylvania Strategic Sourcing Initiative (PSSI) is well documented in the 2008 Audit Report issued by the Legislative Budget and Finance Committee (LB&FC) entitled, ***"A Review of the Commonwealth's Strategic Sourcing Initiative in Procuring Goods and Services"*** conducted pursuant to Senate Resolution 2007-41. The Report documents the displacement of small business vendors who previously did business with the Commonwealth.

The negative impact on small business is best illustrated in the responses to the LB&FC questionnaires:

*“Comments indicated that **local businesses suffered decreased sales volume or closed** as a result. When asked how SSI could be improved, several respondents indicated that the single source contracts typically resulting from strategic sourcing **are not in the best interest of vendors or state agencies.**”*

The Report Findings and Conclusions stated:

*“Strategic sourcing has significantly **reduced** the number of small, minority, and Pennsylvania-based companies that participate in statewide Commonwealth procurement contracts. The number of small business vendors doing business with the Commonwealth has been **considerably reduced** since the strategic sourcing initiative.”*

It is noteworthy that the **DGS response**, dated May 12, 2008, to this Audit expressed the need for “a more thorough analysis”:

“The report documents the reduction in the number of small businesses who held contracts with the Commonwealth and repeats claims by some of the businesses that the program drove them out of business. The Commonwealth is doing business with a smaller number of suppliers at a lower cost as a result of Strategic Sourcing.”

The DGS response continues,

“However, before inferences may be drawn about the impact of Strategic Sourcing on the small business economy in Pennsylvania overall, a more thorough analysis should be done.”

Bornstein & Song suggests the “more thorough analysis” should include a Cost-Benefit Analysis.

What is Strategic Sourcing?

Strategic Sourcing has been promoted as an effective procurement vehicle in the **Private Sector** and has saved billions. Since 2002, the Government Sector has sought to duplicate these savings. More than 30 States have adopted strategic sourcing, and in 2005 the Federal Government decided to begin the process of implementing Federal Strategic Sourcing Initiative (**FSSI**) for all government spending. In June, 2010, the first FSSI was applied to the procurement of Office Supplies.

The essence of strategic sourcing centers on two fundamental precepts: 1) **Spend Analysis**, and 2) **Leveraging**. While Spend Analysis is a valuable tool which makes the procurement process more efficient and results in cost savings, Leveraging poses a problem when applied in the **Public Sector**.

Leveraging of purchasing power awards contracts to **a select few**, while displacing the vast majority of small business vendors. The plight of these displaced small business vendors is of **no consequence** for the **Private Sector**, but it is different in the **Public Sector**, where the costs of unemployment and the social safety net costs should be of concern as they impact small business and the economy.

Strategic Sourcing is Price Driven rather than Value Driven:

Contracts are Awarded to a Select Few Vendors

Strategic Sourcing seeks “Savings” by awarding contracts to the **Lowest Bidder**, regardless of the overall impact on the other small businesses.

This practice sacrifices small business on the **Alter of Savings**. This may work well in the **Private Sector**, but NOT in the **Government Sector**.

The damage to small business, the “Backbone of the Economy”, is **irreversible**. Strategic Sourcing can be viewed as an **“Unnecessary Self-Inflicted Wound.”**

- **Bornstein & Song Research** found this to be the **key difference** between Strategic Sourcing implemented in the **Public Sector** as compared to the **Private Sector**. In the Public Sector, the displacement of the Small Business Industrial Base and the resulting **job loss** will have significant ramifications which will have a **negative impact for decades to come**.

Bornstein & Song Research: A Lesson from Federal Strategic Sourcing

The first Federal Strategic Sourcing Initiative (FSSI), **implemented in June, 2010**, was applied to the procurement of Office Supplies via the **GSA Schedule 75-Office Supplies (OS2)**. Bornstein & Song has been monitoring its progress from day one.

- The Research **confirmed** that the most significant issue was that the **FSSI shrunk the industrial base of small businesses** by awarding FSSI procurement contracts to a select few while leaving the vast majority subjected to **financial distress** and the **resulting job losses**.

Rather than enhancing competition, the **FSSI restricted competition** and caused significant displacement when there were **only 15 vendors** awarded FSSI contracts **out of the 569 vendors** who were previously selling to the Federal Government in good standing.

The **negative impact** on the Office Supplies small business community was documented by **Bornstein & Song Research** and is evidenced by the fact that since inception in June 2010 through June 2013, the 15 awardees realized increased Federal sales of approximately 140 percent, while the 550+ non-winners realized a loss of more than 40 percent. This was bound to threaten the existence of the non-winning small business vendors.

- **Bornstein & Song FSSI Research has determined** that while the Federal Government claimed FSSI savings, the Economic and Social Costs of the displacement of small businesses and the jobs which may have been lost, **were ignored.**

The calculation of a **Cost-Benefit Analysis** was necessary to properly evaluate whether the FSSI program had caused more harm than good, but, a Cost-Benefit Analysis was overlooked and ignored.

- **The Bornstein & Song FSSI National Surveys** have collected **valuable data on the impact** of FSSI-OS2 on the GSA Schedule 75-Office Supplies community, before that group of vendors closed their doors.

The Bornstein & Song FSSI National Surveys were formulated to **estimate the number of jobs** which have been lost since the inception of the FSSI-OS2 in June 2010 through June 2013.

The Survey results tell a very compelling story of the negative impact of the Federal Strategic Sourcing Initiative on small businesses, their employees, and the US Economy.

There are lessons to be learned from the Bornstein & Song FSSI Research because the same Strategic Sourcing Leveraged Buying Protocol is used in all Strategic Sourcing programs.

The Economic & Social Costs of Job Loss:

Strategic Sourcing displaces a significant number of small businesses while awarding State government contracts to the select few. It would be a big mistake to ignore the risk that Strategic Sourcing will **cost jobs** along with the related **Social Safety Net costs** of unemployment. In a period of high and sustained unemployment, these costs should be given a lot of attention.

A reasonable approach is to perform a **Cost-Benefit Analysis** to incorporate the **net employment effects**, whether good or bad.

- According to economic research performed by Von Wachter, Handwerker, and Hildreth, the “True” Cost of Job Loss includes the loss in Replacement Wages that range between 15 to 30 percent lower than the Pre-displacement wages.
- In another research study issued in August 2014, by the United States Conference of Mayors recognized a 23 percent wage loss in replacement wages after job loss. This study suggests that each job lost will have an economic impact on the worker and the economy.
- Recent economic research conducted by University of Chicago law professors Jonathan Masur and Eric Posner contend that \$100,000 is a reasonable monetary estimate for the cost of each job lost and will have an economic impact for the next 15 to 20 years.

When **evaluating the impact of strategic sourcing** on Small Business and the Economy, Bornstein & Song stresses the need to recognize this Cost of Job Loss along with the other Social Safety Net costs.

As these Costs are incorporated into the **Cost-Benefit Analysis**, the scales may be tipped where the Costs will exceed the Benefits (Savings) and render the Strategic Sourcing program as causing more harm than good.

Other State Governments Have Struggled with Strategic Sourcing

While there are claims for Savings, there were other factors which must be considered. The following appeared in a Strategic Sourcing Audit Report by the City of Portland, Oregon entitled, “*Audit: City of Portland Purchase Plan is a Strategic Failure.*”

- **State of New Mexico**, a legislative finance committee found that all savings achieved were being used to pay the Strategic Sourcing consultant.
- **State of Washington**, initial savings estimates of \$100 million dropped to \$17 million, and the costs in staff time were significant. The state is building its own data system to track highest spending volume by vendor, and is working directly with vendors to lower prices.
- **State of Oregon** told us they had realized savings from Strategic Sourcing, but did not provide us with specific dollar amounts. The top Strategic Sourcing staff who left the State of Oregon after initial implementation of the program said that Strategic Sourcing was languishing and that savings could not be documented.

- **State of Illinois**, a jurisdiction that achieved and validated savings through Strategic Sourcing, is unable to do more than sustain existing contracts unless additional funding is allocated to the program.

The U.S. Small Business Administration (SBA) has endorsed the need for a Cost-Benefit Analysis which quantifies the Economic & Social Costs of Job Loss

- Bornstein & Song informed the SBA that the Federal Strategic Sourcing Initiative (FSSI) required a Cost-Benefit Analysis with emphasis on the Economic & Social Costs of Job Loss.

We made the case for the Cost-Benefit Analysis in a **submission** related to a **Protest** against the implementation of the Federal Strategic Sourcing Initiative.

We were **gratified** when the SBA concurred and included these terms in their letter to the Government Accountability Office (GAO) dated April 11, 2014 in support of a Protest against the FSSI:

“It is the position of SBA that a Cost-Benefit Analysis needs to be performed. “Cost” must include the Economic and Social Cost of Job Loss, not just to individual small business, but to the economy as a whole. SBA believes that this is a reasonable approach to assess negative impact of the consolidation.”

Conclusion:

The proponents of the Pennsylvania Strategic Sourcing Initiative (PSSI) seek “Savings” by awarding contracts to the Lowest Bidder, regardless of the overall impact on the other small businesses.

This practice sacrifices small business on the **Alter of Savings**. The damage to small business is **irreversible** and may be viewed as an **“Unnecessary Self-Inflicted Wound.”**

- Bornstein & Song suggests that a **Cost-Benefit Analysis** must be performed to evaluate the impact on small business and the economy. Most critical to this analysis is the need to **quantify** the **Economic & Social Costs of Job Loss** along with the other **Social Safety Net Costs** which will be borne by the Commonwealth.

According to Bornstein & Song Research, Strategic Sourcing has been known to have a negative impact on small business, taxpayers and the Economy as a whole.

Before the PSSI moves forward there is a need to evaluate the economic and social impact of the PSSI which includes the displacement of small businesses, job losses and unemployment, restricted competition, financial distress, business failures, mortgage defaults and foreclosures, etc. There is a risk in moving forward without this critical analysis.

- **Bornstein & Song Research** has determined that the displacement of the Small Business Industrial Base and the resulting **job losses** will have significant ramifications which will have a **negative impact for decades to come.**

Five Questions for the Department of General Services (DGS)

DGS Determination of the Economic and Social Costs of Job Loss:

According to the 2008 Legislative Budget and Finance Committee Review of the Commonwealth's Strategic Sourcing Initiative in Procuring Goods and Services, the Pennsylvania Strategic Sourcing Initiative (PSSI) has reduced the number of contracted vendors **from 2,261 to only 15 vendors.**

Question

1. **Considering that the PSSI has displaced 2,246 vendors, did DGS determine the impact of PSSI on these displaced small businesses?**

Question

2. **Did DGS attempt to estimate the Economic and Social Costs of Job Loss for the 2,246 displaced small businesses who lost their government business to the 15 PSSI contracted vendors?**

Question

3. **Referring to the Economic and Social Costs of Job Loss, did DGS estimate the Social Safety Net Costs of the jobs lost?**
 - State Unemployment Benefits
 - State Tax Revenue Losses from Individuals and Businesses
 - Economic Loss in Consumer Spending & Purchasing Power
 - Earnings losses associated with job displacement for Individuals and Businesses
 - Social Safety Net Costs of Worker Displacement, Education, and Retraining
 - Credit and Mortgage Defaults and Foreclosures (Housing Market)
 - Other Social Safety Net Costs:
 - Welfare
 - Food Stamps
 - Disability Insurance and Retirement Benefits
 - Health Care Benefits (mainly Medicare and Medicaid)
 - Income Maintenance Benefits
 - Veterans Benefits

DGS Determination of SSI “Savings”:

The Legislative Budget and Finance Committee questioned the Savings. The Committee.....

“had several discussions with DGS officials about the extent to which you can count office furniture or copiers that were never actually purchased as a “savings,” but certainly at some level we would agree that avoiding unnecessary purchases is a cost saving.”

Nevertheless, while the Committee may agree that this may be viewed as “savings,” the question still remains as to how extensive was this practice?

Question

- 4. Will DGS make the determination of “savings” more transparent? Will DGS allow the Committee to verify these “savings”?**

Cost-Benefit Analysis of the PSSI:

Question

- 5. Will DGS perform a Cost-Benefit Analysis of the PSSI program BEFORE it is implemented?**

This is necessary to determine whether the Savings exceed the Costs. The Costs should include the Economic and Social Costs of Job Loss as listed in Question #3.