Meeting the DoD Sequestration Level Cost Cuts Without Cutting Strategy, Programs or Readiness

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Scott E. Chandler
Associate Fellow

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"The single biggest threat to national security is the national debt."
−Former Chairman of the Joint Chiefs of Staff Adm. Mike Mullen,
August 27, 2010[1]

In the 2012 strategic guidance released in January, the president and Department of Defense (DoD) admit the global strategy of this country is now limited in reach and power due to the current restrictive national fiscal environment. The fiscal year (FY) 2013 defense budget incorporates this reality, acknowledging that the new strategic guidance and planned budget are driven by ". . . the national security imperative of deficit reduction".[2]

The Budget Control Act of 2011[3] was enacted August, 2011 to avert sovereign default on the national debt. It included spending cuts but required a Congressional "super committee" to agree on at least $1.2 trillion in additional budget cuts by that November or face mandated across-the-board cuts, or sequestration, for this amount. The super committee failed to achieve agreement, and sequestration-level cuts are now required beginning in FY2013. DoD's share is approximately $55 billion annually for the next ten years. DoD, Congress, and industry all predict defense and industrial-base catastrophe, but this paper provides compelling argument that such cuts are achievable without being forced into drastic changes in national strategy, acquisition, or manning.

By March 2012, the United States had accumulated national debt of $15.6 trillion[4], and 2012 will likely add $1.3 trillion to that figure. Interest on this debt will total $5.5 trillion[5] over the next decade if interest rates rise only gradually from current historically low levels. That is comparable to the total defense budget over the same period. Defense expenditures will decline from $531 billion to $525 billion[6] (FY13 base-level funding), a real reduction of 2.3 percent. This figure already reflects $150 billion in savings over five years beginning in 2010 and new reductions of $259 billion including $60 billion in identified efficiencies plus reductions in manning and procurement.

In the words of Winston Churchill, "Gentleman, we have run out of money. Now we have to start thinking."[7]

Defense goods and services are expensive in part due to unique characteristics of the market: a monopsony buyer with unique demands and standards. But it is also a function of the tortured way government does business. Requirements are out of hand. Oppressive administrative and regulatory burdens, poor public/private-sector relationships, failure to accurately account for costs, failure to leverage the power of multiyear/block buys and use of incremental funding mechanisms, and Congressional interference tremendously increase the cost of defense without contributing to the strategic posture or capability.

To address funding declines, DoD is canceling or stretching procurement programs, increasing oversight through its Better Buying Power and Will Cost/Should Cost efforts, shortening contracting periods in an attempt to increase competition, and hiring thousands[8] of new procurement employees and 350 new auditors "to motivate contractors to reduce their cost structures".[9] While canceling programs and reducing operations do reduce cost, they diminish our nation's security posture and threaten the industrial base, and it is far from clear that further increasing administrative oversight or hiring new motivators will save DoD money. In fact, hiring 350 new auditors at the average annual federal compensation of $123,000[10] will cost DoD at least $45 million per year, and they will motivate perhaps twice as many people at service providers and increase taxpayer costs by $150 million in personnel costs alone.

A better way to tackle this problem is to examine the fundamental costs of defense and look for ways to reduce unnecessary expenditures. However, this is a more difficult problem than it should be. The Government Accountability Office (GAO), in multiple reports[11], notes that accounting for costs is frustrated by weaknesses in the DoD financial system. This makes accumulating and allocating costs, especially indirect costs, difficult. It makes costing military programs tricky to begin with, calculating savings from reducing or canceling programs difficult, and complicates the conduct of business-case analysis (BCA) for sourcing decisions.

Full-cost Accounting

Personnel costs are a critical component of government spending, and the relative compensation between federal employees and the private sector is an important part of cost analysis. Conflicting claims seem to have been authoritatively settled with the January release of the Congressional Budget Office (CBO) report[12] that concluded that federal civilian employee compensation averages 16 percent higher than market. Since CBO reports total DoD civilian compensation is $80 billion annually, potential savings are $12.8 billion. Military compensation shows an even larger gap.[13] Total costs for meaningful comparison of alternatives must be fully burdened including facilities, other overhead, and indirect costs. However, the Center for Strategic and International Studies (CSIS) was critical of government cost estimating methods in its report[14] last year, citing numerous deficiencies that omit actual costs of federal performance. Statute[15] excludes health and retirement benefits from cost analysis, and because public employee benefits are several times that of the private sector, cost analysis can be skewed–adversely affecting sourcing decisions and sneaking costs into decisions that were not considered in the evaluation process. Regardless of these studies, only fair, full-cost analysis can provide the necessary basis for sourcing wisely in a particular business case.

Problems accounting for cost are compounded when proper comparison is interfered with, non-economic preferences are given precedence, or cost is irrelevant to sourcing decisions. Today, statute and policy reserve substantial work exclusively to public sector DoD employees regardless of cost. Inherently governmental functions are correctly reserved to federal employees, but statute[16] also reserves to federal employees all work for "core" functions and at least 50 percent of all depot maintenance. Statute also provides an exclusive advantage[17] of 10 percent, or $10 million, to federal employees, whichever is less, in any public-private cost comparison. In addition to statute, both the Office of Management and Budget (OMB)[18] and

DoD policy[19] embed preference for federal employees and exempt financial analysis for a variety of reasons.

However, previous studies show that taxpayers save at least 30 percent[20] when functions are competed, regardless of who wins. The primary study released in 2004[21] was reported by Jacques Gansler, former Under Secretary of Defense for Acquisition, Technology and Logistics from November 1997 through January 2001. The study reflects competitions through the A-76 process[22] and concludes that "competition creates incentives for higher performance at lower costs (vs. public or private monopolies)." The 2001 FAIR Act Inventory showed 50 percent of public-sector jobs at that time could be subject to competition. The study showed that both performance and savings were retained over time. Part of the savings came from an average 35 percent reduction in personnel positions, but nearly all the displaced federal employees were repositioned in other DoD or federal jobs, were hired by the winning contractor, or opted to retire. If half of the DoD positions were competed and achieved the typical 35 percent manpower savings, potential recovery is $11.8 billion (after allowing for market compensation).[23] However, successive National Defense Authorization Acts (NDAA) have repeatedly prohibited A-76 competitions and forgone available savings. While the CSIS report was critical of the A-76 cost-accounting method, potential savings and performance improvements are clearly proven.

Policy

In April 2009 the government undertook policy-based insourcing. DoD initially claimed 40 percent savings per person insourced[24] but that proved elusive, and by August 2010, then-Secretary of Defense Robert Gates publicly admitted insourcing was not saving money.[25] However, statute and preferences for federal employees remain in place and were further strengthened by the 2012 NDAA[26] that expanded the definition of core functions and depot maintenance reserved to federal employees. It also added a new, fourth layer of protection mandating a yet-undefined "appropriate mix" of contractor, civilian, and military personnel. This last layer replaced the previous statute requiring the secretary of defense to use the least costly form of personnel and explicitly stipulates that establishing this appropriate mix takes precedence over cost. Thus, both statute and policy deliberately include provisions either blocking or frustrating full cost-based decision making. "History is clear: The absence of potential competition leads inexorably to cost growth."[27]

Good Contracting

Traditional contracting policy for other than development has typically been transactional, but such terms leave government and provider with opposing incentives. However, outcome-based strategies are based on payment tied to performance. In such contracts, transactions are cost events to government and provider alike, so cost reduction incentivizes both. Partnerships between government and provider can optimize use of capabilities on both sides. Regardless of contract, terms must be carefully constructed to allow incentives to work. There is little point and higher cost to short contracts when maintenance intervals far exceed contract length, and there is little point to partnership without long-term commitment between both parties.[28]

Advanced funding for procurement of materials, multiyear procurements, and block buys are other contracting mechanisms that would enhance cost reduction of major weapons platforms.

Anyone who shops at Costco or BJs knows buying in bulk saves money. The Virginia-class attack submarine program reduced cost by $400 million, or 20 percent, per submarine while inserting enhanced capabilities.[29] This success has been replicated in other programs with multiyear procurements such as the F/A-18 E/F, the V-22 Osprey, and defense satellites.

Related to the use of multiyear procurements and block buys is the application of the principle of incremental funding. Today, for example, DoD fronts all money in advance when it buys a ship. The Pentagon should amortize the cost for each major procurement (e.g., aircraft carrier, destroyer, submarine, F-18s, F-35s, Stryker vehicles, etc.) and expend the budgeted funds to match the portion of production occurring in a given year. This would also avoid tens of billions of dollars wasting in untouchable accounts, waiting years to be expended in the final touches to a warship.

Regulatory Burden

Perhaps the greatest potential for cost savings from today's budget lies with costs associated with compliance with complex and intrusive federal statute and policy. In 1994, the landmark Coopers & Lybrand study[30] found a DoD regulatory cost premium of 18 percent. This is the estimated premium DoD pays for the same item sold to a purely commercial customer. Other studies at the time put that figure as high as 50 percent. A 2001 Rand study[31] reviewed all of these studies and concluded the potential savings, given an improved regulatory environment but similar framework, to be 3.5 percent of purchases. However, DoD internal infrastructure to monitor, audit, and enforce regulatory burden represents additional cost to taxpayers that must also be considered.

A better estimate of potential savings are commercial-like programs that Rand reports produce typical savings potential range from 15 percent to 35 percent, and as high as 60 percent.[32] Contract length alone is typically worth 5 percent. Project Proof Point[33] showed that all performance-based logistics (PBLs) with contract lengths of four years or more demonstrated price-to-service reductions. Overall, Project Proof Point predicts a conservative savings estimate of 10 to 20 percent every year of the $90 billion in annual sustainment spending. That's $9 billion to $18 billion in potential savings. The Aerospace Industries Association provides its estimate is $16 billion to $21 billion.[34] DoD annual spending for all services is $200 billion, and for acquisition, $99 billion.[35] Realistic savings of $11 billion are possible (after eliminating savings from outcome-based sustainment) if only 5 percent of this amount is saved through restructured oversight and outcome-based contracting strategies.

A landmark example of effective contracting and effectiveness of commercial-like programs is acquisition of the Joint Direct Attack Munitions (JDAM). Initial unit cost estimates approached $68,000[36] in 1995. Nevertheless, the USAF must-cost target was $40,000. However, the first contract award was for $18,000 each. By late 2010, almost 190,000 units had been delivered with a then average unit price of approximately $20,000.[37]

Currently, DoD is trending toward shorter contracts to provide more frequent opportunity to compete sourcing between industry providers. However, this is based on a faulty premise. Short contracts greatly increase contracting overhead and time, discourage potential bidders from investing with little protection of returns, and neutralize incentives for improved

performance that require investment. One effective contracting strategy would be allowing automatic contract extensions for excellent performance and cost reduction.

The DoD regulatory burden is a heavy premium on traditional purchasing, and it has been many years since last review. Referring to the Coopers & Lybrand report in a March report on doing business with the Department of Defense, the House Armed Services Committee reported, "Despite the many acquisition reform efforts have taken place since that time, it is likely that costs, due to added regulations, have only increased. [sic]"[38] A new, comprehensive review is needed to assess the impact of current legislation and regulation, to determine potential improvements to streamline and simplify, and to investigate promoting other constructs such as outcome-based contracting that hold promise for reduced cost and improved performance.

Excellence

Another cost-reduction strategy is simply excellence. The Government Accountability Office High Risk[39] series lists six areas where DoD continues to struggle: financial management, weapon systems acquisition, supply-chain management, approach-to-business transformation, business systems modernization, and support infrastructure management. All of these areas are critical to understanding and minimizing cost and to effectively supporting the warfighter in the field. For example, supply-chain management has been on the GAO high-risk list for more than twenty years. Last year GAO reported 28 percent of supplies and spare parts inventory in September 2009 were excess or exceeded acquisition objectives.[40] At that time, 9 percent of all inventory had had no demand in at least five years, and 8.5 percent was on-order excess inventory. For spare parts alone, 52 percent of the Defense Logistics Agency's (DLA) parts were beyond requirements objectives at the same time it experienced inventory deficits.[41] Inaccurate forecasting was the leading reason for excess inventory. The Air Force improved its forecast accuracy to 40 percent in 2009, up from 29 percent in 2008. A stretch goal of 70 percent for 2011 was established, but officials felt that would be difficult to achieve. Government has never done this well. AIA estimates savings of $2.8 billion to $3.7 billion per year by partnering with industry to manage the supply chain.[42]

One of the most transformative factors in the modern global economy is end-to-end supply-chain visibility and just-in-time delivery. One of the most effective things DoD can do to reduce costs is to achieve excellence in the activities it reserves to itself or to source those activities where excellence can be found.

Good Relationships

Much harder to quantify but obvious from experience is that the U.S. government is a notoriously difficult customer. It is a monopsony buyer, often both the largest customer and largest competitor (e.g., maintenance and service), and it makes all the laws. The government can and does cancel contracts for convenience; changes requirements, purchase quantities, or schedules at will; demands proprietary information even for commercial products for distribution to competitors; dictates contract terms and controls margins. All of these things cause havoc with costs and business plans. A 2009 report commissioned by DoD shows defense industry operating margins were half those of the S&P 500.[43] In March, a new report by Deloitte[44] put industry operating margin at 10.5 percent, almost 60 percent lower than for business overall. These reports demonstrate at least two things: DoD has received good value

for a long time from industry suppliers, and there is little potential to absorb budget cuts from industry margin. In many ways, industry suppliers would better serve shareholders in any business other than providing products and services to DoD. DoD should be careful lest it find itself without a ready industrial base prepared to deliver the weapon systems it needs to effectively execute its global strategy and provide for the common defense.

Recent DoD statements promise industry margins are not a target of cost cutting, but this policy does not seem to have flowed to the contracting organizations. There are both successful contracts and partnerships between government and industry–and awards are bestowed every year. However, difficult customers present enormous risk to suppliers that must be monetized. Many potential suppliers will not embrace such customers; thus, the government deprives itself of a broader pool of potential suppliers that can sustain effective competition. If government is serious about saving money, it needs to be a low-risk, stable, and reliable customer − and good partner.

Cost in Perspective

Cost savings available from these fundamentals are not small.[45] Achieving market-level labor costs, engaging public-private competition, moderating red tape, using appropriate contracting approaches and sensible contract lengths can meet both currently planned costs cuts and sequestration-level cuts *without impacting procurement, sustainment, readiness, manning, or strategy.* We should pursue cost-reduction opportunities wherever they exist, but, as with every thorny problem, solutions start with fundamentals.

First priority in defense must be keeping ships, aircraft, and tanks ready to support a long-term strategic posture and foreign policy driven by the global threat rather than by budget limitations. Anything that does not add value to that imperative should be ruthlessly cut out. Legislation and policy that mandate non-economic preferences, remove options and incentives for cost reductions, interfere with full-cost analysis, or diminish readiness or capability have no place in any situation compromising national strategy.

The Department of Defense needs a new acquisition process that addresses major unnecessary sources of expenditures. Reforming the requirements process would be one important step. Equally important is creating a defense acquisition environment based on full and fair competition across a single, integrated defense-industrial base.

Congress must remove legislative roadblocks to best value by eliminating arbitrary earmarks to federal employees beyond inherently governmental functions, and it must eliminate administrative overhead without clear benefit. DoD must have a financial system that fully understands its costs and applies that information for rigorous full-cost analysis to allow sourcing wisely. It must be a good customer and embrace a holistic view of government-industry partnership. If we don't rectify the existing pervasive, fundamental fiscal dysfunctions and instead hollow the defense, Gen. Martin Dempsey, Chairman of the Joint Chiefs of Staff, tells us "we would no longer be a global power."[46]

End Notes

[1] Department of Defense, National Debt Poses Security Threat, Mullen Says, Press release, August 27, 2010.

[2] Department of Defense, Sustaining U.S. Global Leadership: Priorities for 21st Century Defense, January 3, 2012.

[3] Budget Control Act of 2011, August 2, 2011.

[4] Department of the Treasury Bureau of the Public Debt, Monthly Statement of the Public Debt of the United States, March 31, 2012, March 31, 2012.

[5] Sahadi, J. (2011, February 2). Interest on national debt: 'Skyrocketing' costs ahead. *CNN Money,* Retrieved from CNN website April 18, 2011: http://money.cnn.com/2011/02/02/news/economy/interest_national_debt/index.htm

[6] Department of Defense. Defense Budget Priorities and Choices, January 3, 2012.

[7] Farrell, P. F. Jr. "Gentlemen, we have run out of money; now we have to think." *National Defense*, Nov 2011;96, 696, Page 4.

[8] Tiron, R, Lynn: Government must take care with Pentagon reform, The Hill, May 6, 2009. Early administration plans called for hiring 20,000 new personnel for acquisition alone by 2015. At $123,000 per federal employee average (see end note 10), that's $2.5B per year. At time of publication, the author does not know how many have actually been hired.

[9] Sweetman, B., McLeary, P. (2012, January 6). Budget Cuts Force Procurement Rethink, Aviation *Week & Space Technology*. Retrieved from the Aviation Week & Space Technology website, April 18, 2012: http://www.aviationweek.com/aw/generic/story_generic.jsp?channel=dti&id=news/dti/2012/01/01/DT_01_01_2012_p65-404781.xml

[10] Cauchon, D., Federal workers earning double their private counterparts, August 13, 2010. Retrieved from USA Today website April 18, 2012: http://www.usatoday.com/money/economy/income/2010-08-10-1Afedpay10_ST_N.htm

[11] Government Accountability Office. GAO-06-1006T, Sustained Leadership is Critical to Effective Financial and Business Management Transformation, August 3, 2006. (among others)

[12] Congressional Budget Office. Analysis of Federal Civilian and Military Compensation , Publication No. 4403, January 30, 2012.

[13] Congressional Budget Office. Analysis of Federal Civilian and Military Compensation, Letter to the Honorable Steny H. Hoyer, January 20, 2012.

[14] Center for Strategic International Studies (CSIS), DoD Workforce Cost Realism Assessment, May 17, 2012.

[15] Public-Private Competition Required Before Conversion To Contractor Performance, 10 USC § 2461.

[16] Core Logistics Capabilities, 10 USC § 2464; Limitations on the performance of depot-level maintenance of materiel, 10 USC § 2466.

[17] 10 USC §2461, op. cit.

[18] Office of Management and Budget, Memo on Managing the Multi-Sector Workforce, July 29, 2009. Attachment 3, Page 2. "… there may be circumstances where performance and risk considerations in favor of federal employee performance will clearly outweigh cost considerations." In such cases, full cost analysis is unnecessary. The criteria given include "the agency needs to establish or build internal capacity to maintain control of its mission and operations". This definition is broad enough to allow wide discretion to insource without cost analysis.

[19] Department of Defense, DoDI 1100.22 Guidance for Determining Workforce Mix, April 12, 2010. Page 2. "… risk mitigation shall take precedence over cost savings…". This document defines what functions are exempt from private sector performance regardless of cost. A variety of reasons are given which together allow broad discretion.

[20] The White House Office of Management and Budget, Executive Office of the President Office of Management and Budget. *COMPETITIVE SOURCING - Conducting Public-Private Competition in a Reasoned and Responsible Manner,* July 2003. End note 2: "DoD, which has, by far, the most extensive program for public-private competition, estimates savings of 33 percent on the roughly 3000 competitions it has conducted since 1979. Numerous sources outside the executive branch also have confirmed the benefits of public-private competition. See, e.g., *Long-Run Costs and Performance Effects of Competitive Sourcing*, Center for Naval Analysis, CRM D0002765.A2 (February 2001) (16 competitions yielded estimated effective savings of 34 percent through the life of the contracts); *Personnel Savings in Competitive Sourced Activities: Are They Real? Will They Last?*, National Defense Research Institute, RAND (2002) (expected savings for contractor wins ranged from 41-59 percent and for the government employees from 34-59 percent); *Moving Toward Market-Based Government: The Changing Role of Government as the Provider*, IBM Endowment for The Business of Government (June 2003) (the presence of competition creates the previously missing incentive for government providers to significantly improve processes that lower costs and increase performance*); COMPETITIVE SOURCING: Implementation Will Be Key to Success of New Circular A-76*, GAO-03-943T (June 26, 2003) (the new Circular should result in increased savings, improved performance, and greater accountability)."

[21] Gansler, J. *COMPETITIVE SOURCING: The results to date*, University of Maryland School of Public Affairs Center for Public Policy and Private Enterprise, November 15, 2004.

[22] The White House Office of Management and Budget, Executive Office of the President, Office of Management and Budget. Circular A-76 Revised, May 29, 2003.

[23] If DoD competed 50 percent of civilian positions, potential savings are 50 percent times $80B minus 16 percent savings already taken for market personnel rates times 35 percent fewer positions, or about $11.8B annually.

[24] Air Force Material Command. AFMC Resource Management Decision 802 In-Sourcing Implementation Guidance, January 2010.

[25] Department of Defense. News briefing with Secretary Gates from the Pentagon, August 9, 2010.

[26] National Defense Authorization Act for Fiscal Year 2012, Sections 321, 327, and 931.

[27] CSIS, op. cit.

[28] Slobodow, B., Abdullah, O., Babuschak, W., When Supplier Partnerships Aren't, *MIT Sloan Management Review*, Volume 49, No. 2, January 2008.

[29] RDML (sel.) Johnson, D. C., Drakeley, G. M., &. Smith, G. M. Engineering the Solution: VIRGINIA Class Submarine Cost Reduction, October 10, 2010.

[30] Department of Defense. The DoD Regulatory Cost Premium: A Quantitative Assessment, Coopers & Lybrand, 1994.

[31] Rand Corporation. An Overview of Acquisition Reform Cost Savings Estimates, 2001.

[32] Ibid.

[33] Boyce, J., Banghart, A. Performance Based Logistics and Project Proof Point: A Study of PBL Effectiveness. Defense AT&L, March-April 2012. *Volume XLI*, No. 2, Page 26.

[34] Aerospace Industries Association (AIA). Modernizing Defense Logistics, June 25, 2009.

[35] Department of Defense Budget Fiscal Year 2013, Office of the Under Secretary of Defense (Comptroller), Procurement Programs (P-1), February 2012.

[36] Rand Corporation, op. cit.

[37] Selected Acquisition Report (SAR) RCS: DD-A&T(Q&A)823-503. JDAM. Retrieved from the Internet April 23, 2012: http://www.dod.gov/pubs/foi/logistics_material_readiness/acq_bud_fin/SARs/DEC 2010 SAR/JDAM - SAR - 25 DEC 2010.pdf Estimated current price - page 25. Delivered units - page 34.

[38] House Committee on Armed Services. Challenges to Doing Business with the Department of Defense - Findings of the Panel on Business Challenges in the Defense Industry, March 19, 2012.

[39] Government Accountability Office. GAO-11-278, High-Risk Series – An Update, February 2011.

[40] Government Accountability Office. GAO-11-240R, DoD's 2010 Comprehensive Inventory Management Improvement Plan Addressed Statutory Requirements, But Faces Implementation Challenges, January 7, 2011.

[41] Government Accountability Office. GAO-10-469, Defense Inventory - Defense Logistics Agency Needs to Expand on Efforts to More Effectively Manage Spare Parts, May 2010.

[42] AIA, op. cit.

[43] Institute for Defense Analysis. Defense Department Profit and Contract Finance Policies and Their Effects on Contract and Contractor Performance, February 2, 2009.

[44] Deloitte. The Aerospace and Defense Industry in the U.S. – A financial and economic impact study, March 7, 2012.

[45] The sum of savings potential mentioned in this article approaches $60B compared to the $55B estimated for sequestration-level cuts. The potential savings are realistic because calculations are relatively conservative and they don't include all potential savings. For example, DoD will purchase $80B in supplies each year, but no savings were included due to possible double booking within services and acquisition spending, and the author cannot now differentiate those costs. In addition, no savings are credited for potential improvements in the remaining five areas on GAO's high-risk list not discussed. Nor are savings included that might be available through better government-industry relationships. All of this leaves room for a potential inability to capture all potential savings identified and still have realistic potential savings comparable to sequestration-level cuts. However, even if DoD were to immediately embrace the concepts outlined in this monograph, legislative, policy, and contracting lead-time would frustrate near-term implementation. However, sequestration would be a ten-year issue so savings posited in this paper remain relevant to addressing the problem of sequestration. Of course, DoD should continue its other efficiency initiatives as well.

[46] Baldor, L., Senators clash over making more Pentagon cuts; defense leaders warn of greater risks, Associated Press, February 28, 2012.

About the Author

Scott E. Chandler is an Associate Fellow at the Lexington Institute with more than 30 years experience in commercial and military aviation. He has degrees from MIT, Carnegie Mellon, and RPI.

1600 Wilson Boulevard, Suite 900 | Arlington VA 22209
T: 703-522-5828 | F: 703-522-5837
mail@lexingtoninstitute.org | www.lexingtoninstitute.org