Town of Lexington

MEMORANDUM

TO: Board of Selectmen; Appropriations Committee, Capital Expenditures Committee, School Committee

FROM: Jim Malloy, Town Manager; Carolyn Kosnoff, Assistant Town Manager for Finance; Jennifer Hewitt, Budget Officer

DATE: May 7, 2019

RE: Fiscal Policy Review

PREFACE

It is a best practice for communities to have an established, written set of fiscal guidelines for reference by town staff and financial boards to ensure consistency and continuity. While the Town of Lexington has followed many best practices and guidelines over the years and is currently in a strong financial position, we do not have a comprehensive set of documented policies or guidelines. The purpose of this memoranda is to provide policy makers with background information and context on Lexington's current fiscal policies, practices and guidelines, and to highlight areas for further review and discussion.

The information in the memoranda was compiled from multiple sources including the Final Report of the Ad Hoc Fiscal Policy Advisory Committee from 2006; a 2014 Policy on OPEB Adopted by the Board of Selectmen, past budget documents, presentations, documentation files and from the knowledge of Town Staff. This document is not intended to be an exhaustive list of the Town's policies and practices, but may be useful in preparing for upcoming policy discussions, short- and long-term financial planning and annual budget preparation. In the coming months Town Staff will begin to document policies and guidelines with input from the Town's boards and committees to ensure transparency and consistency in the Town's financial planning process.

Key areas of focus for the upcoming Fiscal Policy Summit on May 15, 2019 are as follows:

- Eliminating Use of Free Cash for the Operating Budget
- Tax to the Levy Limit vs. Creating Excess Levy Capacity
- Personal Property Tax New Growth
- Use and Funding of Stabilization Funds
- Strategy and Commitment for Funding OPEB

LEXINGTON'S CURRENT GOALS AND OBJECTIVES

The following overriding goals apply to all of the policy areas noted herein:

- Develop a fiscally responsible, balanced budget each fiscal year.
- Avoid the need for an operating override for either municipal or school operations.
- Stabilize the change in residential tax bills from one year to the next through use of fiscal reserves, where feasible.
- Maintain the Town's AAA bond rating to minimize the costs of future debt issuances, particularly for the high school.
- Prioritize investments in the Town's physical assets in a way that minimizes operating expenses and maximizes the useful life of the assets. Develop and utilize a long-term capital plan for prioritizing capital project requests.
- Establish and maintain fiscal policies that address the goals above, as well as the establishment, funding and use of fiscal reserves.

OUTLINE OF CURRENT LEXINGTON FISCAL POLICIES

Current and recommended policies fall under a number of different areas, which are outlined below, with further detail provided in the remaining pages. A number of current policies originated in a 2006 Report from the Ad Hoc Financial Policy Committee, which is attached as an appendix for reference purposes.

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I. OVER-ARCHING POLICIES

The policies below reflect the higher level fiscal principals which govern decision making for the various boards and financial committees for the overall operating budget and capital plan.

a. LONG-TERM FORECAST – 10-15 YEARS

Town Staff have historically presented a 3-year forecast as part of the initial Budget Summit, and the Appropriation Committee develops a 5-year forecast in their annual report to Town Meeting. For the FY2020 budget, Town Staff developed a 5-year forecast, and intend to continue this practice going forward. In order to develop a more realistic outlook, particularly with the anticipated fiscal challenge of replacing the high school, a 10-15 year projection should be developed, which will provide context for making other fiscal decisions, particularly around funding and utilizing reserve funds, and establishing annual tax rates.

b. FISCAL RESERVES

In general, the Town should establish reserve funds for specified purposes, but should also actively use them when the anticipated need arises. Such reserves are a best practice and indicate solid financial management, which are key indicators reviewed by the rating agencies in their annual recertification of the town's AAA bond rating.

All fiscal reserves are invested and earn interest that accrues to the individual reserve funds. Investments in the Pension and OPEB Funds are managed by the Town Retirement Board and are invested in a diversified portfolio including equity and fixed income securities. The General Stabilization Fund is invested by the Town Treasurer in short-term liquid securities; and the remaining funds, including the Capital Stabilization Fund are invested in the MMDT account with the State Treasurer, which currently earns an interest rate of approximately 2%.

i. Pension Funding – State Law requires that all public pension funds are managed to reach full funding status by 2040, but the Public Employee Retirement Administration Commission (PERAC) has a goal to have each retirement system reach full funding by 2035. This funding status is determined by an actuarial evaluation which factors in multiple variables including investment and discount rates, mortality rates and data from actual pension plan participants. Lexington conducts a full actuarial valuation every two years, including updated assumptions, and conducts an update for interim years. Given current assumptions, Lexington's pension fund is currently 87.1% funded, and is on track to fully fund the obligation by 2024. At that point, the annual assessment will be reduced by more than $4 million, providing an opportunity to fund other financial needs.

The projected Pension Funding schedule is displayed below for context, and is based on the actuarial valuation as of January 1, 2018. Note that future actuarial valuations and changes in actuarial assumptions may have an impact on the funding schedule below.

Appropriation Forecast

Fiscal Year Ending	Payroll*	Employee Contribution	Employer Normal Cost with Interest	Amortization Payments with Interest	Employer Total Cost with Interest	Employer Total Cost % of Payroll	Funded Ratio %**
2019	$38,607,665	$3,439,198	$1,494,975	$4,510,562	$6,005,537	15.6	87.1
2020	40,345,010	3,629,643	1,524,244	4,881,293	6,405,537	15.9	89.1
2021	42,160,535	3,830,264	1,553,121	5,202,416	6,755,537	16.0	91.1
2022	44,057,759	4,041,591	1,581,509	5,524,028	7,105,537	16.1	93.3
2023	46,040,359	4,264,181	1,609,308	5,846,229	7,455,537	16.2	95.6
2024	48,112,175	4,498,620	1,636,406	4,819,867	6,456,273	13.4	98.1
2025	50,277,223	4,745,523	1,662,683	0	1,662,683	3.3	100.0
2026	52,539,698	5,005,538	1,688,012	0	1,688,012	3.2	100.0

ii. Other Post-Employment Benefits (OPEB) Funding – The Town of Lexington established an OPEB Trust Fund in 2002 to begin funding its obligations to provide health insurance to current and future retirees. Unlike the Pension Fund, the State of Massachusetts has not mandated that municipalities fully fund their OPEB obligations.

Similar to the Pension Fund, the Town conducts a biennial actuarial valuation and annual update of its OPEB Trust Fund. As of June 30, 2018, the OPEB Trust Fund had a net liability of $138M. In 2013, the Town began to slowly fund the OPEB obligation, and in 2014, the Board of Selectmen established a policy of funding 35-100% of the OPEB Normal Cost in each fiscal year to address this liability.

Recent years have provided a steadily increasing contribution from both the General Fund and Enterprise Funds. The General Fund sources have been from a combination of Free Cash, and a $750,000 annual transfer from the Health Claims Trust Fund. The balance in the fund is sufficient to continue those contributions through FY2023, with a partial contribution in FY2024. The recent FY2020 budget funded approximately 21% of Normal Cost ($1,879,721 of $8,930,723 attributed to General Fund).

As of June 30, 2018 GASB standards changed and biennial valuations will no longer reflect a normal cost. Therefore, the funding policy will need to be revisited.

Staff recommends continued annual contributions to the OPEB liability through FY2023, funded from a mix of the Health Claims Trust Fund and transfers from Free Cash, increasing by $50,000 per year. In FY2024, the Health Claims Trust Fund will be depleted and the remainder could be made up from the Tax Levy. As noted previously, this same year will have a reduced pension assessment as that obligation approaches full funding, thereby freeing up tax levy revenue that can be allocated to other financial needs.

Beginning in FY2025, when the Pension Fund is expected to be fully funded, a more aggressive OPEB funding schedule could be implemented.

The following tables present the historical and anticipated fund balance and activity in the OPEB Trust Fund and the Health Claims Trust Fund:

Historical Levels of OPEB Funding *5/1/2019*

	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024
Opening Balance	$ 4,482,338	$ 5,798,656	$ 7,997,042	$ 10,532,069	$ 13,137,657	$ 15,845,902	$ 17,731,388	$ 19,667,162	$ 21,653,239	$ 23,689,634
Additional Contributions										
Tax Levy*	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ 325,000
Health Claims Trust Fund*	$ 1,000,000	$ 1,858,947	$ 1,200,000	$ 750,000	$ 750,000	$ 750,000	$ 750,000	$ 750,000	$ 750,000	$ 425,000
Free Cash**	$ 119,000	$ 3,247	$ 312,318	$ 1,079,721	$ 1,079,721	$ 1,129,721	$ 1,179,721	$ 1,229,721	$ 1,279,721	$ 1,329,721
Water/Sewer	$ -	$ -	$ -	$ 13,174	$ 13,174	$ 5,765	$ 6,053	$ 6,356	$ 6,674	$ 7,007
Total OPEB Contribution	**$ 1,119,000**	**$ 1,862,194**	**$ 1,512,318**	**$ 1,842,895**	**$ 1,842,895**	**$ 1,885,486**	**$ 1,935,774**	**$ 1,986,077**	**$ 2,036,395**	**$ 2,086,728**
Fund Gains/(Losses)	$ 197,318	$ 336,192	$ 1,022,708	$ 762,693	$ 865,350	$ -	$ -	$ -	$ -	$ -
Ending Balance	$ 5,798,656	$ 7,997,042	$ 10,532,069	$ 13,137,657	$ 15,845,902	$ 17,731,388	$ 19,667,162	$ 21,653,239	$ 23,689,634	$ 25,776,362

**Because the Health Claims Trust Fund can only be used for health insurance costs, the transfer from that fund to the General Fund frees up tax levy funds that are then used for OPEB. For presentation purposes, that two-step transfer is shown as one for FY2015-19.*

***Free Cash must be appropriated by Town Meeting. If certified Free Cash is not fully appropriated by June 30th, the balance will go to fund balance, and will be included in the amount of Free Cash certified for the following year.*

Health Claims Trust Fund	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024
Opening Balance	$ 8,567,189	$ 7,559,595	$ 5,693,188	$ 4,540,875	$ 3,851,400	$ 3,178,612	$ 2,500,824	$ 1,818,035	$ 1,130,247	$ 437,459
Transfers to General Fund	$ (1,000,000)	$ (1,858,947)	$ (1,200,000)	$ (750,000)	$ (750,000)	$ (750,000)	$ (750,000)	$ (750,000)	$ (750,000)	$ (425,000)
Transfers to Special Revenue Fund	$ (178,405)									
Expenses	$ (5,196)	$ (75,641)								
Revenue	$ 160,951	$ 43,851	$ 6,486	$ 328						
Interest Earnings	$ 15,054	$ 24,330	$ 41,202	$ 60,197	*$ 77,212*	*$ 72,212*	*$ 67,212*	*$ 62,212*	*$ 57,212*	*$ -*
Ending Balance	$ 7,559,595	$ 5,693,188	$ 4,540,875	$ 3,851,400	$ 3,178,612	$ 2,500,824	$ 1,818,035	$ 1,130,247	$ 437,459	$ 12,459

Because a significant portion of OPEB Funding is taken from the HCTF, this chart is provided to show actual activity in the HCTF from FY2015 when it was first tapped for OPEB, and projecting forward until the fund is fully depleted in FY2024.

DOR has asked the Town to transfer the balance of the HCTF more quickly. Staff have deferred action, preferring to show a consistent transfer from the operating budget to OPEB to demonstrate a commitment to fund OPEB for the ratings agencies.

iii. General Stabilization Fund – In the 2006 report, the Ad Hoc Committee recommended the establishment of a General Stabilization Fund to offset potential future shortfalls in State Aid and Local Receipts. Given that Free Cash was the primary reserve at that time, a target of 7% of the prior year's General Fund revenue was established. The balance in the General Stabilization Fund as of April 8, 2019, is $9,719,462, or 4.7% of FY2019 projected net General Fund revenue. An infusion of $4.8 million would be needed to achieve the recommended 7% level from 2006.

Given the existence of numerous additional reserves and fund balances which did not exist in 2006, and the numerous additional pressures on the town's finances, staff do not recommend continued funding of the General Stabilization Fund at the current time. The Town enjoyed several years of aggressive growth Chapter 70 Aid, which has leveled off in the last two years as the Town has reached its minimum aid threshold set by the Department of Education. Staff expect Chapter 70 funding will be stable in the coming years.

The current balance in the General Stabilization Fund is approximately 30% of the Town's total State Aid and Local Receipts revenue. This would allow the Town to absorb a 30% decrease in these revenues for 3 consecutive years. The balance in the General Stabilization Fund should be monitored annually in conjunction with economic and legislative trends. If a decrease in either State Aid or Local Receipts is anticipated, the Town should consider setting aside additional funds to address future revenue needs.

The following table presents the General Stabilization Balance as a % of State Aid and Local receipts for the previous three fiscal years.

	FY2017	FY2018	FY2019
State Aid	$ 15,737,052	$ 15,996,335	$ 16,187,516
Local Receipts	$ 16,738,858	$ 13,727,959	$ 14,086,885
Gen'l Stab. Balance	$ 9,447,867	$ 9,649,865	$ 9,719,462
% State/Local Rev.	29.09%	32.46%	32.10%

Going forward staff and policy makers may want to revisit the purpose of the General Stabilization Fund, its target funding levels, and guidelines for utilizing these reserves. The original purpose was to restore lost State and/or Local revenue; and staff suggest that should be maintained. However, State Aid is expect to be stable, and other economic pressures such as inflation may impact the budget in coming years. If a transfer from the Fund is voted, the method to restore funds in future years should be identified, and acknowledged in future budgets.

iv. Capital Stabilization Fund – Staff and policy makers anticipated several large capital projects being implemented in a short period of time (reconstruction of school buildings, public safety, and other municipal infrastructure projects). Establishing and funding the Capital Stabilization Fund (CSF) was a key strategy to address these future capital needs. The Town has aggressively funded the CSF over a number of years, reaching a peak balance of over $28M in FY2018. To accomplish this, the Town's practice has been to tax to the Levy Limit and set aside surplus revenues into this fund for future use.

This fund has primarily been used to reduce the annual increase in tax bills from exempt debt service for projects which were approved by the voters via debt exclusions. However, in recent years the CSF has also been used to stabilize the impact of within levy debt on the operating budget.

Staff's modeling projects that transfers into the fund will be surpassed by transfers out of the fund for the next 5 years, and that the balance of the CSF will decrease significantly during this time. Future funding and use of the CSF should be topics for discussion by policy makers. In particular, the following items should be addressed –

1. Future transfers into the CSF (including re-building the fund to address a future High School reconstruction project);
2. Use of funds for Within Levy Debt Service (current practice is to ensure that within-levy debt service does not grow by more than 5% per year);
3. Used of funds for Excluded Debt Service (currently used to mitigate increases in residential tax bills to 4.0% or less)

The following table present the history and future balance of the CSF. This model was recently updated to reflect the outcome of the 2019 Annual Town Meeting.

History of Capital Stabilization Fund (CSF)				
	Appropriations and Interest into the CSF	Anticipated Use of CSF for Within Levy Debt	Anticipated Use of CSF for Excluded Debt	Ending Balance
FY2013	$1,601,835	$0	$0	$1,601,835
FY2014	$3,988,868	$0	($1,600,000)	$3,990,703
FY2015	$5,926,762	($919,000)	($950,000)	$8,048,465
FY2016	$9,513,048	($215,000)	($620,567)	$16,725,946
FY2017	$7,187,263	$0	($710,000)	$23,203,209
FY2018	$8,119,224	($324,500)	($2,400,000)	$28,597,933
FY2019	$3,560,335	($573,500)	($4,500,000)	$27,084,768
FY2020 (1)	$1,536,759	$0	($5,200,000)	$23,421,527
FY2021 (est.)	$0	($1,910,000)	($6,200,000)	$15,311,527
FY2022 (est.)	$0	($1,474,000)	($4,000,000)	$9,837,527
FY2023 (est.)	$0	($1,329,000)	($2,200,000)	$6,308,527
FY2024 (est.)	$0	($1,025,000)	$0	$5,283,527
FY2025 (est.)	$0	($198,000)	$0	$5,085,527
FY2026 (est.)	$0	$0	$0	$5,085,527
FY2027 (est.)	$0	$0	$0	$5,085,527
FY2028 (est.)	$0	$0	$0	$5,085,527
(1) As appropriated at 2019 Annual Town Meeting				

v. Other Stabilization Funds – The Town is fortunate to have a number of additional funds available for either ongoing or one-time expenditures. The current balance of these funds is noted below, along with a description of the source of funding and anticipated uses.

Specialized Stabilization Funds	FY2016	FY2017	FY2018	as of 3/28/19
Special Education Stabilization Fund	$ 1,078,170	$ 1,088,001	$ 1,105,262	$ 1,120,867
Debt Stabilization Fund	$ 895,503	$ 778,494	$ 664,828	$ 549,506
Transportation Demand Management	$ 300,766	$ 214,309	$ 226,906	$ 181,379
Traffic Mitigation Stabilization Fund	$ 147,401	$ 146,701	$ 321,751	$ 354,948
TMOD Stabilization Fund	$ 98,164	$ 98,263	$ 333,310	$ 342,445
Center Improvement Stabilization Fund	$ 86,872	$ 87,664	$ 61,628	$ 35,190

- The Special Education Stabilization Fund was established to cover any unanticipated special education expenses that may arise in a given year that cannot be covered in the operating budget. This includes new students moving into the district or the needs of current students changing in an impactful way. No new deposits have been made since FY2011, but the fund continues to earn interest each fiscal year.
- The Debt Stabilization Fund was initially established as a holding account for an MSBA payment that was received after a project was fully funded. These proceeds

are being used to offset debt service for that project. Each year, Town Meeting authorizes a transfer for that purpose. The fund will be depleted in FY2023, which coincides with the maturity of the bond for that project.

- The following funds were established to reserve payments from developers and property owners that were paid to the Town to mitigate negative traffic impacts or improve transportation. Typically these payments related to projects where zoning changes were approved or new developments were built. These payments are a mix of one-time and ongoing revenues.
  - Transportation Demand Management (TDM) is used to supplement tax levy support for the Lexpress bus service and the 6-year pilot program for the REV Shuttle.
  - Traffic Mitigation funds are used for making targeted traffic and pedestrian safety improvements. These funds are allocated at the recommendation of the Transportation Safety Group.
  - Transportation Management Overlay District (TMOD) funds are directed to infrastructure improvements in the Hartwell corridor.
- The Center Improvement Stabilization Fund has been funding the 3-year Bike Share pilot program at Economic Development.

vi. Other Available Funds – In addition to the Stabilization Funds, the Town has a number of Special Revenue Funds with significant available balances that are being held in reserve for particular purposes. The current balance is noted below, along with a description of the source of funding and anticipated uses.

Name of Fund	FY2016	FY2017	FY2018	Balance as of 4/30/19
PEG TV Special Revenue Fund	$ 904,114	$ 1,069,481	$ 1,338,459	$ 1,160,444
DPW Compost Revolving Fund	$ 1,099,754	$ 1,013,807	$ 891,356	$ 626,357
Sale of Cemetery Lots Fund	$ 556,683	$ 616,900	$ 651,051	$ 629,329
Parking Fund	$ 691,817	$ 717,006	$ 944,365	$ 1,015,156

- The PEG TV Special Revenue Fund receives the proceeds from cable contracts in town, and uses them to fund the operating costs for LexMedia, as well as a portion of the AV Technician at DPF. The fund balance has been used in the past to upgrade technical equipment at Cary Hall and the Selectmen's meeting room.
- The Compost Revolving Fund receives revenue from issuing disposal permits to landscapers, as well as selling the finished compost. The fund balance is paying for ongoing debt service for new equipment purchased to allow the facility to continue to maintain the same level of service on a smaller footprint.
- The Sale of Cemetery Lots Fund receives a portion of the fees generated from selling cemetery plots. The fund balance will potentially fund debt service for the replacement of the Westview Cemetery Building (if it is authorized by Town Meeting) or to pay for future capital improvements at the Town's cemeteries.

- The Parking Fund receives the proceeds from parking meters and the Depot parking lot, and transfers funds to the General Fund each year to pay for parking enforcement and snow removal. The fund has also been used to fund Electric Vehicle Charging Stations and is available to fund replacement of municipal parking lots if needed.

vii. Continuing Accounts – There are three General Fund accounts which are authorized to have their balances roll forward from one year to the next. The purpose of each account is described below, and the intent of these dedicated reserve funds is to provide a pool of sufficient funds to cover expenses in future years. Historical activity and current balances noted in the chart are as of March 28, 2019.

- Workers Compensation – The Town is self-insured for Worker's Compensation claims (excluding public safety positons) and this account funds any claims that arise. The Town has used $1M as a target balance to maintain in this account, and past appropriations were increased each year in an effort to grow the balance to that level. Since the account has reached the target $1 million balance, annual appropriations are set at levels which reflect historical expenses. In the event of an unexpected, or series of unexpected losses, the account balance could be utilized, though the Town has a stop-loss policy to cover extraordinary losses. The premium for the stop-loss policy is also paid from this account.

- Uninsured Losses – This account covers and deductibles for the Town's general liability insurance along with other non-covered expenses. The Town Manager's Office plans to rebid the Property & Liability Insurance policies in FY2020, and may establish higher deductibles if policy premium savings would be achieved.

- Salary Transfer Account – Each year, a projection is made for the financial exposure for unsettled municipal collective bargaining contracts in the coming year. Sick time and vacation buyback projections are also incorporated. These amounts are then available in future years for transfer to department personal service accounts. If a department is able to absorb the increases, the amounts in the Salary Transfer Account are allowed to fall to Free Cash.

Workers Compensation

	FY2016	FY2017	FY2018	FY2019	FY2020
Beginning Balance	$ 729,589	$ 882,112	$1,004,223	$1,197,807	$1,671,707
Appropriation	$ 643,112	$ 747,665	$ 807,136	$ 882,380	$ 887,346
Expenditures	$ 490,589	$ 625,554	$ 613,552	$ 408,480	
Ending Balance	$ 882,112	$1,004,223	$1,197,807	$1,671,707	

Uninsured Losses

	FY2016	FY2017	FY2018	FY2019	FY2020
Beginning Balance	$ 547,279	$ 623,795	$ 832,675	$ 962,713	$1,196,031
Appropriation	$ 200,000	$ 225,000	$ 250,000	$ 250,000	$ 250,000
Expenditures	$ 123,484	$ 16,121	$ 119,961	$ 16,683	
Ending Balance	$ 623,795	$ 832,675	$ 962,713	$1,196,031	

Salary Transfer Account

	FY2016	FY2017	FY2018	FY2019	FY2020
Beginning Balance	$2,095,397	$1,724,713	$1,877,696	$ 531,958	$1,014,988
Appropriation	$ 820,316	$ 673,016	$ 750,592	$ 483,030	$ 750,594
Transfers Out	$ 591,000	$ 120,033	$1,646,330		
Drop to Free Cash	$ 600,000	$ 400,000	$ 450,000		
Ending Balance	$1,724,713	$1,877,696	$ 531,958	$1,014,988	

viii. Free Cash – Over a number of years, the Town has generated an increasing amount of Free Cash. Free Cash is generated from surplus revenues (revenue exceeding what was projected in the budget), and by spending less than originally budgeted. Free Cash is considered a one-time revenue source that may vary from year-to-year. Best practices indicate that one-time revenues should be used for one-time expenses, and not for continuing expenses, such as those in the operating budget. In Lexington Free Cash has been used for a variety of purposes, including to support the operating budget, summarized in the table below.

Under the direction of the Town Manager, a concerted effort was started in FY2020 to reduce the amount of Free Cash used to support the Operating Budget. Staff further recommend that future use of Free Cash focus on one-time expenses, such as cash capital or the funding of reserves accounts.

Area	FY2016	FY2017	FY2018	FY2019	FY2020
Operating Budget	$4,080,920	$3,918,300	$3,853,023	$3,740,000	$2,900,000
Cash Capital	$2,419,000	$2,500,000	$3,350,000	$4,050,245	$4,400,000
OPEB Funding	$3,247	$312,318	$1,079,721	$1,079,721	$1,129,721
Capital Stabilization Fund	$6,405,035	$3,100,000	$5,000,000	$502,085	$1,536,759
Retire Note – Land Purch.	-	-	-	$3,050,000	$2,234,614
Getting to Net Zero		$40,000	$40,000	-	-
Unallocated*		$924,961	$565,125	$480,000	$1,000,000
Set-Aside - Current Year*	$200,000	$200,000	$200,000	$160,000	$200,000
Total Free Cash	**$13,108,202**	**$10,995,579**	**$14,087,869**	**$13,062,051**	**$13,401,094**

**If funds are not used for the budget, the balance falls to Free Cash again*

ix. Overlay Account Balances – The "Overlay" is an annual revenue offset built into the budget to cover tax abatements and exemptions. Prior to the Municipal Modernization Act (Muni Mod), the Town was required to maintain adequate overlay account balances in distinct accounts by fiscal year, with sufficient amounts in each account to cover potential claims. Passage of Muni Mod allows the Town to combine overlay accounts, thereby allowing balances from one year to cover exposures in another year and potentially freeing up excess account balances. Staff recommend conducting an annual review of the Overlay account with the Board of Assessors, including current balances and potential exposures. If it is determined that the overlay balance is more than sufficient to cover potential claims, a portion of the Overlay balance may be released by the Board of Assessors. These funds would revert to the General Fund and could be put into other reserve accounts or used for one-time expenses.

II. Operating Budget

The strategies below reflect the governing policies and procedures which provide a framework for staff to use in preparing the annual operating budget recommendations.

a. Budget Summits

Lexington is fortunate to have a robust and active set of policy making boards and committees. The annual budget is arguably the most important policy document developed each year. In order for the budget to be developed in a cohesive, consistent way, the Town has developed a practice of holding a series of Budget Summits throughout the Fall and Winter which bring together the 4 key groups: Board of Selectmen, School Committee, Appropriation Committee and Capital Expenditures Committee. The purpose of the Summits is to share key fiscal information across all stakeholder groups, and provide a forum for discussion and collective decision-making.

The current Summit schedule, and other key milestones, is –

- Summit #1 – key financial indicators and out-year forecast,
- Summit #2 – revenue forecast for budget year, initial revenue allocation
- Summit #3 – finalize revenue allocation, discussion of other budget concerns
- Summit #4 – presentation of Town Manager's preliminary recommended budget (White Book) and Superintendent's preliminary recommended budget
- Summit #5 – follow-up conversation, if needed
- Late February – Select Board votes to recommend budget; released to Town Meeting
- Late March – Town Meeting votes on recommended budget

b. Tax to the Levy Limit

Helpful Definitions –

- Proposition 2½ – The law passed in 1980 which limits the rate at which the base tax levy can grow to 2.5% each year.
- Levy Limit – The total amount the Town can raise via property tax bills. The levy limit is calculated by taking the amount raised in the prior year, adding 2.5%, adding any new growth during the year, and finally, adding any operating overrides. If the Town has

voted projects as excluded debt, that amount is added to the Levy Limit to get to the Maximum Allowable Levy.

- New Growth – The taxed amount from newly created residential, commercial and personal property value in any given year. This incremental increase in value is created by an improvement, new construction, or a new asset.
- Override – Taxpayers can vote to exceed the Levy Limit in two ways –
    - Operating Override – results in a permanent increase to the Levy Limit, compounded by 2.5% per year.
    - Debt Exclusion – authorizes the Town to issue debt for a capital project. The debt service is added to the levy limit and is recalculated each year. Once the bonds for a project have been paid, no further obligations above the levy limit are required.
- Tax to the Levy Limit – This is the approach the Town of Lexington has practiced for many years, along with many other communities. The tax rate is calculated to raise an amount as close to the Levy Limit as possible in a given year. In recent years, it has been the Town's policy to transfer any excess funds to the Capital Stabilization Fund, or other one-time uses, rather than build up the operating budget to the full tax capacity. The reserves are planned for use in future years as a way of offsetting or preventing an override vote.

c. EXCESS LEVY CAPACITY

If a community does not tax to the Levy Limit, there is excess capacity available under the levy limit that remains untaxed. That revenue is not raised in the levy in a given year, and therefore is not available to spend or earn interest. The result of leaving levy capacity untaxed will be relatively lower tax bills for that particular fiscal year. However, excess levy capacity is available to be taxed in future years, meaning that base tax bills in those years could grow by more than 2.5%.

Taxing to the Levy Limit versus creating Excess Levy Capacity will be a key decision point for staff and policy makers at the upcoming fiscal policy summit. If the Town elects to begin building excess Levy Capacity, we will need an additional policy to determine when that excess levy capacity should be utilized in future years.

d. PERSONAL PROPERTY NEW GROWTH

As previously noted, under Proposition 2½, the base tax levy can grow by no more than 2.5% in any given year. In addition, a community can recognize New Growth which is added to the base tax levy in that particular year and becomes part of the base tax levy in all future years.

Examples of New Growth are best understood in the following categories –

- RESIDENTIAL – A home that is valued at $500,000 is purchased and torn down, resulting in a new home valued at $1,500,000. In the first year, the incremental $1,000,000 is added to the base tax value, and the residential tax rate is applied. In the second year, the base tax on the home increases by 2.5%, assuming no further improvements. Other examples that would trigger "new growth" for a home would be an addition or other improvement to the property. Change in market value of a property is not considered new growth.

- COMMERCIAL/INDUSTRIAL – As with residential, if a commercial or industrial property is improved or added during the year, any incremental increase in value is added to the base for the tax calculations.

- PERSONAL PROPERTY – This category is primarily made up of durable equipment purchased or acquired in commercial and industrial business. Unlike residential and commercial new growth, many of these newly acquired personal property assets depreciate in 5 years or less and are often on a short-term replacement schedule. These assets may be sold or disposed of shortly after being purchased.

  The result is that the value associated with personal property new growth may disappear from the Town's total property valuation shortly after being recognized as new growth. However, there is no mechanism in the Proposition 2½ formula for the value to be removed from the levy limit calculation, so the associated tax levy is redistributed to the remaining taxpayers.

  Whether or not the Town should address the impact of Personal Property New Growth will be a key decision point for staff and policy makers at the upcoming fiscal policy summit.

e. REVENUE FORECASTING

Lexington has traditionally been very conservative in forecasting revenues for the coming year, rather than striving for amounts that may not be achieved and result in a deficit. In general, the following principles are followed –

- Property Tax Revenue – projected to increase by 2.5%, with New Growth limited to $2.5M.

- State Aid – Chapter 70 is based on a per pupil increase, known as minimum aid; and Unrestricted Government Aid growth is based on historical averages.

- Departmental Revenue – budgeted levels for the current year are set to adjust based on the historical 3-year averages, unless further background is known about a revenue source.

- Available Funds – where feasible, alternative funding sources for budgetary items are identified and transferred to the General Fund, with the biggest variable coming from the amount of Free Cash certified each year.

- Revenue Offsets – these include state aid assessments and offsets (MBTA, MAPC, library, etc.) which are projected to grow 3.5%; the Overlay account for potential tax abatements which is typically funded at $750,000, or $900,000 during a recertification year; and a set-aside for potential snow deficits, which has been traditionally funded at $400,000.

- Enterprise Receipts – collected from the Water, Wastewater and Recreation enterprise funds for General Fund expenditures made on their behalf – also known as Indirect Costs. A detailed analysis for each fund is updated each year, and is used to determine the amounts to transfer.

f. FUNDING SHORT-TERM CAPITAL VIA OPERATING BUDGET

As a practice, Lexington has sought to incorporate the routine replacement of smaller capital items into its operating budget. This is a best practice in that it ensures that items are replaced as needed, and it ensures there is sufficient capacity in the budget to continue that replacement over time. Examples include –

- School Department – replacement of furnishings and equipment for staff and students, initiated in FY2019
- Police Department – routine replacement of police cruisers
- Fire Department – routine replacement of fire protective equipment and command vehicles; a PIR was funded for $85,000 in FY2020 to provide an extra set of turnout gear for the significant number of new staff members in recent years, due to staff turnover.
- Public Facilities – routine replacement of maintenance tools and vehicles, the maintenance of security cameras, and a new initiative in the FY2020 budget to fund classroom and office painting.
- Public Works – routine replacement of town passenger vehicles, managed by DPW for other departments; ongoing maintenance, repair and replacement of guardrails.
- Other – as needed, departments request one-time funding to replace or add new equipment. Recent examples include a wheel balancer for the Equipment Maintenance division at DPW, a mower for the Conservation Commission, and an electronic plan table for the Building and Zoning department.

g. WITHIN LEVY DEBT SERVICE

For projects funded by debt, and the subsequent debt service payments are funded within the Town's base operating budget, the debt service is referred to as "Within Levy" debt service. Those expenses are constrained by the limits of Proposition 2½. In principle, the Town has strived to limit growth in within levy debt service to no more than 5% from year-to-year. Maintaining a consistent level of debt service avoids crowding out other expenses in the operating budget. This should be accomplished by limiting the value of debt-financed projects funded in the capital budget each year.

In practice, the appetite for capital projects has grown in recent years, resulting in higher within-levy debt service costs. In order to limit within levy debt service growth to 5% per year, transfers have been authorized from the Capital Stabilization Fund (CSF), as noted in section I.(b)(iv). To maintain the 5% growth in debt service noted above, staff anticipate that transfers will be needed in FY2021 through FY2025, for a total of approximately $5.9M. This includes debt for projects that have been authorized but not yet issued, so the exact amount may vary.

Staff recommends that this guideline be reevaluated in upcoming budget cycles for several reasons. First, given the Town's commitment to funding and maintain its valuable capital assets, and our current level of funding capital projects with cash, a target growth of 5% in debt service may not be adequate to continue funding our ongoing capital programs. Second, revenues have historically averaged less than 5% growth each year, therefore the growth in debt service is outpacing the growth in revenues.

h. <u>EXCLUDED DEBT SERVICE</u>

Larger capital projects are typically brought to the taxpayers to be authorized via a "Debt Exclusion," which means the debt service needed to fund the project is not subject to the limits of Proposition 2½. An affirmative vote by the majority of voters in a townwide referendum is needed to exclude a project from the limits of Proposition 2½. The Town's goal has been to stabilize the year-over-year increases in excluded debt and hold them to a manageable level, thereby reducing the impact on the residential and commercial tax bills. To accomplish this, the town has increasingly used the Capital Stabilization Fund (CSF) as a funding source to offset the impact of excluded debt service, and "shave the peak" of anticipated growth. Projected use of the CSF is illustrated in section I.(b)(iv).

i. <u>REVENUE ALLOCATION MODEL</u>

For many years, the Town has utilized a method known as the Revenue Allocation model to project and allocate new revenues for the coming budget year. This involves a number of steps –

1. Project all sources of revenue for the coming year,
2. Subtract the following expenses –
    a. the municipal and school budgets from the prior year,
    b. projected Shared Expenses such as pension funding, employee benefits, within levy debt service, the department of Public Facilities, and other commitments,
    c. agreed upon funding for set-asides, such as transfers to the Capital Stabilization Fund and OPEB, cash capital including street improvements and municipal buildings, and paying down land purchase principal,
3. Split any remaining funds proportionally between municipal and school, based on the prior year's budget levels.
4. The amount from #3 is added to the amounts in 2(a) to provide the target budget levels for each budget.

By establishing target budgets in the early stages of budget development, staff can more easily anticipate needs and develop alternate arrangements. For many years, it had been the accepted practice to return some of the Revenue Allocation funding, which would then be added to the Capital Stabilization Fund. Those funds would also be available in the following year to provide a higher revenue allocation. However, in FY2020, both the municipal and school departments fully budgeted their allocated revenue.

j. <u>LEVEL-SERVICE BUDGETS</u>

Each year, departments are instructed to propose a level-service budget, which means they anticipate providing the same services from one year to the next, though providing the same service may need increased funding due to outside factors. If management wishes to propose a programmatic enhancement, they submit a Program Improvement Request (PIR), which outlines the proposal, the rational for the request, the funding needed, and the ongoing costs.

k. <u>FUNDING PROGRAM IMPROVEMENT REQUESTS (PIRS)</u>
In general, PIRs that propose a one-time expenditure are preferred over those that establish an ongoing commitment. PIRs which create efficiencies, future cost savings, or are environmentally sustainable, are also preferred. The Town Manager, with input from department heads and policy makers, makes the ultimate recommendation on which PIRS will be funded in any given year. Revenues must be available to fund any PIRs that are recommended by the Town Manager.

l. <u>SCHOOL ENROLLMENT PROJECTIONS</u>
A major cost driver in recent years has been the growth in school enrollment at all levels, but especially at the high school. School staff have developed detailed projections to anticipate future enrollment growth. To better ensure that the Town has sufficient funds set-aside to educate all of its children, policy makers prefer to project enrollments at realistic levels. However, there is always a potential for actual enrollments to vary from projections.

m. <u>SNOW AND ICE BUDGET</u>
State law requires the Town to set-aside the same amount as it budgeted in the prior year. Lexington does this, and adds anticipated increases due to contractual obligations, fuel costs and other expenses. However, snow removal is a notoriously difficult item to project. If spending exceeds budgeted levels, other sources of funding which can cover the overage include –

- Other items within the DPW personal services and expense budgets;
- Allocations from the Reserve Fund, as approved by the Appropriation Committee; and
- Carrying forward a portion of the deficit to the following year, to be raised in the tax levy, as anticipated in the Set-Aside revenue budget.

The actual experience over the past 10 years is detailed below.

Fiscal Year	Budget	Actual	Surplus/ (Shortfall)	Transfers within DPW Budget	Reserve Fund Transfers	Year End Deficit Raised in Next Fiscal Year
2018	$ 1,257,822	$ 1,628,760	$ (370,938)	$ 70,938	$ —	$ 300,000
2017	$ 1,188,024	$ 1,685,467	$ (497,443)	$ 232,193	$ —	$ 265,250
2016	$ 1,128,216	$ 1,196,662	$ (68,446)	$ 68,446	$ —	$ —
2015	$ 1,127,716	$ 2,235,573	$ (1,107,857)	$ 464,207	$ —	$ 643,650
2014	$ 1,091,534	$ 1,744,540	$ (653,006)	$ —	$ —	$ 653,006
2013	$ 1,091,534	$ 1,448,098	$ (356,564)	$ 149,564	$ 207,000	$ —
2012	$ 1,004,944	$ 603,900	$ 401,044	$ —	$ —	$ —
2011	$ 987,445	$ 1,884,338	$ (896,893)	$ 242,840	$ —	$ 654,053
2010	$ 737,445	$ 1,396,285	$ (658,840)	$ 658,840	$ —	$ —
2009	$ 646,925	$ 2,282,115	$ (1,635,190)	$ 1,533,443	$ —	$ 101,747
Total	**$ 10,261,605**	**$ 16,105,738**	**$ (5,844,133)**	**$ 3,420,471**	**$ 207,000**	**$ 2,617,705**

III. CAPITAL BUDGET

a. <u>DEFINITION OF CAPITAL PROJECT</u>

A capital project is defined as a major, non-recurring expenditure that generally meets the following criteria:

- Massachusetts General Law permits the Town to issue bonds to finance the expenditure;
- The expenditure is $25,000 or more;
- The expenditure will have a useful life of 10 years or more for buildings or building components and 5 years for vehicles and equipment; and
- Planning, engineering, or design services may be considered capital when such services are integral to a construction, renewal or replacement project that meets the criteria for a capital expenditure.

b. <u>PRIORITIZED CAPITAL PLAN</u>

Under the direction of the Town Manager, the Town is currently developing an overall list of anticipated capital projects over the next 5 or more years, and will prioritize them using a set of to-be-determined criteria. It is anticipated that this process will better enable Lexington to constrain its capital budget.

c. <u>TARGETED CASH CAPITAL INVESTMENTS</u>

Fiscal leaders are very interested in limiting the issuance of new debt, particularly for items which have a shorter useful life, such as information technology. Wherever possible, cash funding streams are used to finance those projects, rather than debt.

d. <u>ANNUAL LIMITS ON AUTHORIZED WITHIN LEVY DEBT PROJECTS</u>

In principle, the Town has strived to limit growth in the General Fund capital budget (including cash and debt financed projects) to an increase of 5% per year. In practice, the appetite for capital projects has grown in recent years, resulting in capital budgets that far exceed the 5% target. This has the trickle-down effect of increasing within levy debt service costs, which in turn requires transfers from reserves.

e. <u>USE OF CAPITAL STABILIZATION FUNDS</u>

To-date, the Capital Stabilization Fund (CSF) has not been used to fund a project directly, but rather to offset the debt service for that project, thereby minimizing the annual increase required for residential tax bills. Going forward, particularly for the high school, leaders should consider whether to use the CSF to avoid the need to issue debt, thereby saving both interest and issuance costs.

f. <u>USE OF OTHER FUNDS</u>

Capital projects may be funded with cash or debt from the General Fund, from Enterprise Funds, from the Community Preservation Act (CPA) fund, or from a small subset of other funds, including stabilization, special revenue and revolving funds that are available for funding capital improvements. See section I.(2)(vi) and I.(2)(vii) for additional information.