

Interim Report

Of the

Ad Hoc Fiscal Task Force

Presented to: Board of Selectmen
Date: July 10, 2009

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Executive Summary

The Fiscal Task Force appointed by the Board of Selectmen has met weekly since early May to gather information concerning the town's fiscal situation and to consider what advice to offer the Board and other town decision-makers. Our major findings and recommendations are summarized as follows:

Summary of Findings

1. Fiscal Context

- The growth of the town's revenues has slowed markedly in the economic downturn and will only recover over a period of years. The duration of the economic downturn is difficult to predict, but is likely to last into 2010 or beyond.
- Due to steeply declining state revenues, state aid has already been cut by nearly 10 percent, may decline further, and will only recover slowly.
- Property tax revenues are relatively stable, although their impact on taxpayers increases as taxpayers' incomes and property values decline, and growth in the tax base from new construction will be substantially reduced during the economic downturn.
- Local receipts and available free cash will likely be significantly below the levels of recent years for the duration of the downturn.
- Expanding the town's commercial property tax base is an important priority and will relieve pressure on residential taxpayers. Important steps have already been taken by recent Town Meeting actions, but it will take time for these actions to reap benefits.
- Lexington has experienced annual revenue growth of as much as 6 % in recent years. If growth is reduced to zero, as may well occur in FY 2011, the difference is about \$8 million each year.
- Town operating expenses are expected to continue to rise, largely due to inflation in employee health benefit costs, along with other employee compensation costs and special education costs.
- The single most important factor driving the growth in operating expenses is the continuing double-digit increase in employee and retiree health benefit costs. Slowing the growth in these costs is of highest importance for the town's short- and long-term fiscal health.
- Present estimates suggest that costs for FY 2011 will grow by about \$4 million, plus an additional \$800,000 for each percentage-point increase in employee wage agreements.
- The town faces continuing demands for capital expenditures to maintain and replace our assets. These demands have been less than fully met by recent authorizations of about \$4 to 5 million annually. In addition, the town faces several large capital projects that will need to be funded by voter approval of debt exclusions from Proposition 2 ½.
- The town has been successful in setting aside financial reserves in recent years, resulting most significantly in a stabilization fund balance of \$6.8 million and an additional \$700,000 reserve for unbudgeted special education costs.

2. Fiscal Outlook for FY 2011 and FY 2012:

- In light of all the above factors, the consensus estimates of the Appropriation Committee and town staff identify a budget gap of approximately \$4 million for FY 2011, plus an additional \$800,000 per percentage point of any employee cost-of-living increase.
- The Appropriation Committee forecasts a larger gap of \$5 to 7 million for FY 2012.
- These estimates are subject to a great many uncertainties, on both the revenue and the expense side. As new information comes in, it will be vital to continue to update the estimates.

Summary of Recommendations

1. Recommendations for FY 2011 and 2012: In light of these anticipated budget gaps, the task force identified a menu of strategies that the town should consider for FY 2011. These same measures will provide an appropriate foundation for planning for FY 2012:

- Exercising maximum restraint in compensation: In light of present economic circumstances, the town must make every effort to limit growth in total employee compensation (salaries plus benefits). In particular, highest priority must go to achieving substantial, lasting and pervasive savings in employee health benefit costs.
- Capital spending: The town should consider increased use of borrowing to defer an additional portion of capital costs, and should perhaps also consider some modest deferrals of capital maintenance.
- Retirement obligations: The town should consider some modest deferrals in funding of obligations for retiree pension and benefit costs.
- Discretionary cost restraint: The municipal and school administrations should continue, during FY 2010, to take all prudent measures to hold down operating costs, by deferring filling of non-critical hiring and careful review of purchases.
- Early identification of possible cost reductions: Municipal and school staff should identify \$1 million of potential program reductions, equitably allocated between town and school budgets. Such reductions should only be implemented to the extent that the other strategies identified here are insufficient to close the budget gap.
- Broadening the tax base: The town should adopt, at the earliest feasible time, the new local-option taxes recently authorized by the legislature (additional 2% hotel/motel tax and 0.75% meals tax). In addition the town will receive an additional \$500,000 annually from the repeal of the property tax exemption for telephone company poles and wires.
- Grant and stimulus funding: The municipal and school departments should take all reasonable measures to pursue any grant funding to cover costs of existing programs.
- Use of stabilization fund: The town should make use of the stabilization fund to maintain municipal and school services and facilities. These funds will also be needed in FY 2012 and perhaps beyond. Depending on circumstances and the outlook beyond FY 2011, the town could draw between \$2 and 3 million from the fund for FY 2011.

2. General recommendations: Looking at the town's longer-term fiscal situation, beyond the challenges of the upcoming budget cycle, the task force offers several more general recommendations. These should inform decision making both in the current budget cycle and beyond:

- Exercising maximum restraint in total compensation: As in FY 2011, this will remain an essential priority for the next several years.
- Proposition 2 ½ operating overrides: As the financial downturn abates, and when appropriate steps have been taken to restrain the growth in total compensation costs, it will again be appropriate to give Lexington voters the choice whether to increase property taxes when needed to maintain services.
- Rebuilding reserves: As the downturn abates, it will be essential to rebuild the town's reserves, to the level of 7% of general fund revenues, in a timely fashion.
- Service restructuring and innovation: Even during periods of budgetary constraint, the town should remain open to incremental spending necessary to implement more cost-effective ways to provide services.

3. Long-Term Issues for further consideration: The focus of this report is primarily on issues of significance in planning for the FY 2011 and FY 2012 budgets. The task force also has identified a number of issues of longer term significance, but has not had the opportunity to fully review them or arrive at recommendations. These topics include: the large menu of large capital projects facing the town; the uses of Community Preservation Act funding; long-term compensation policies; effective planning for program restructuring; and issues on the state legislative agenda.

Introduction

After a period of sustained economic growth and appreciation in asset values, Lexington's government and Lexington citizens face much more challenging circumstances. We expect pressure—likely for a sustained period—on the revenues available to pay for public services (municipal and schools).

It is important to note that the single most important source of local revenue, property taxes, is essentially stable and by law can grow 2.5 percent annually (plus any increment from new growth in the tax base). This is in welcome contrast to the sudden, severe reduction in Commonwealth revenues, for example, where taxes on economically sensitive bases—personal income, capital gains, retail sales, and business income—have fallen dramatically short of expectations. Likewise, in Lexington, a number of the town's secondary sources of revenue, particularly local aid, new property growth, and local receipts from automobile excises and building permits, have been severely impacted by the current economic crisis.

The Commonwealth's experience reminds us that the relative stability of the local property tax *base* is not at all the same thing as robust growth or even stability in townspeople's financial circumstances. Few of our fellow citizens (and fellow taxpayers) are receiving *increases* in compensation in the current circumstances; many are struggling with significant *reductions* in compensation or other sources of income, or prospective or outright loss of jobs. Moreover, townspeople have seen their education and retirement savings diminished.

The work of this task force, and this report, focus on the challenges of financing public services on which we all depend, daily and for the long term. But both are informed by the equally challenging circumstances our fellow citizens face in the wake of the credit crisis and the current recession. We recognize as well that Lexington's skilled, highly valued employees and their families are affected by the prevailing economic anxieties.

In the most recent rating-agency assessment of Lexington's finances, Moody's Investors Service made note of the pressures arising from "cyclical revenue declines...without corresponding expenditure reductions," and the expected reduction in the town's financial flexibility, giving rise to possible "structural challenges in future fiscal years." This report will give meaning to those generalities.

We aim to suggest a policy context for discussion not only among all of Lexington's officials—the *Selectmen* (who commissioned this task force), the *School Committee*, *Town Meeting*—but also among *the town and school administrations*, *the public at large*, and all of our *municipal and school employees*. All of these stakeholders will, in common, make the choices that steer our community through the current challenge soundly and appropriately.

In the discussion that follows, we emphasize the following overlapping points:

- We recognize, and emphasize, that we face a very high degree of uncertainty about how the economic and fiscal pictures (for nation, state, and town) will unfold over the next several years. All of the predictions and recommendations that follow will need to be frequently reassessed in light of new information and changing circumstances.

•We have not always reached consensus on how best to proceed. That is to be expected where there are differences of opinion on Lexington’s best options, informed by diverse values and interests. It is all the more so in the current economic context, where the fiscal outlook is highly uncertain. *Where our discussions have revealed alternate courses of action, we have tried in this report to illuminate those alternatives and their underlying rationales, the better to inform the public debate and decisions that lie ahead.*

•It will be tempting to focus debate, above all, on the disposition of the stabilization funds that Lexington has wisely accumulated to see us through “rainy days”—or even more threatening storms. *How to use these reserves naturally looms as an important decision. But it is not the only issue—nor, in the long term, may it even be the most consequential issue for Lexington’s fiscal health and the strength of the community we cherish.*

•The annual budget imposes a familiar and welcome discipline. *But any decisions we make have short- and longer-term consequences.* Do we fund current operations by deferring maintenance and repair of our physical facilities and infrastructure—potentially incurring higher costs in the future, when borrowing costs may be higher? Do we tighten current operating budgets so severely that we choke off innovations that deliver both near-term savings and enhanced services (such as investing in in-school special-education programs, or in energy-conservation systems)? How do we allocate stabilization fund resources for current needs, while maintaining a margin for potentially worse fiscal circumstances in succeeding years? *Finding the proper balance—more art than science—will involve nimble, responsive, inclusive, and public-spirited work by all of Lexington’s stakeholders.*

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Fiscal Context

The task force started its work by seeking the best currently available information about the town's likely fiscal circumstances over the next several years. In this section, we summarize our current understanding of the town's revenues, operating expenses, capital requirements, and reserves for the next few fiscal years.

Revenue growth has slowed markedly. The table in Appendix A, Historical and Projected Revenues: FY07 to FY11, depicts this trend. Gross general fund revenues increased about 6 percent in each of FY 2008 (including the effects of the June 2007 operating override) and FY 2009. Based on current estimates of FY10 revenue that reflect provisions of the recently adopted FY2010 state budget, that rate of growth has dropped to approximately 4 percent. Preliminary projections of FY2011 revenue prepared by town staff, show marginally negative growth. Prominent causes of this shift include:

- The collapse in Commonwealth tax collections (sensitive to incomes, employment, and capital gains; translates into reduced state aid to local communities). Lexington's budgeted aid declined approximately \$760,000, or 7.8 percent, in FY 2010, reversing average growth of 8.5% in the preceding two years. Town staff's preliminary projection of FY2011 state aid is that it will remain at its FY2010 level.

- The likely decline in "local receipts" revenue, driven by factors such as: decline in new automobile sales (translates into reduced local excise-tax collections); lessened building activity (reduces permit fees); and prevailing low interest rates (reduces investment income on town fund balances).

- The uncertain outlook for "new growth" both of buildings and of business personal property and equipment (which has provided a substantial increment to the property tax base in favorable years, averaging \$2.6 million over the last 3 years, \$2.3 million over the last 5 years and \$2.0 million over the last ten years). Note that the substantial development at Lexington Technology Park (the Shire headquarters) approved at a special town meeting in fall of 2007 will, over a period of years, significantly expand the commercial tax base (adding an estimated \$2.5 million in annual revenue); however, under the terms of the incentive agreement approved by that special town meeting, those new revenues will be gradually phased in over a 20-year period.

"Unreserved fund balance," or "free cash," another significant source of funds available for appropriation, has tended to increase in strong economic periods (driven in part by better than predicted local receipts and new growth). That funding source is now expected to diminish as well.

The difference between 6 percent and zero revenue growth is about \$8 million in incremental funds.

Note that *Massachusetts lagged the nation in entering the recession* and losing jobs. In previous recessions, *Massachusetts has often lagged in recovering—and recovery in state aid to localities has lagged even further behind*, as the state struggles to repair its own finances. From FY 2002 through FY 2005, state aid declined by an aggregate 18 percent, and then did not return to the nominal FY 2002 level until FY 2009 (still representing *a sharp decline in real aid*, since this level of assistance was *not* adjusted for inflation).

National economic forecasters suggest that growth may resume from later in 2009 to sometime in 2010, but that employment growth will not resume immediately. The New England Economic Partnership forecasts suggest a regional recession lingering well into 2010. Whatever forecast one chooses to adopt, the current reversal in state aid could remain a drag on local finances for a protracted period. Recovery in state aid to the level prevailing at the beginning of FY09 will almost certainly take several years.

Operating expenses have historically risen each year, reflecting both contractual agreements for the workforce (municipal and school) and, particularly, continued inflation in employee health-benefit costs. Debt-service costs will rise as the town pays for capital improvements (both within the regular budget for relatively minor debt-funded items and outside of it for exempt debt for the new Department of Public Works facility). And as a buyer of motor fuels and utilities for facilities, Lexington has some exposure to energy-cost increases, although the town has prudently locked in prices for electricity and natural gas through FY 2012. Town staff's planning assumptions, as depicted in Appendix B, suggest that on the current course, expenses for FY 2011 would behave as follows:

- *Education costs* rise approximately \$2 million, reflecting increased special-education expenses and employee compensation-step increases, offset in part by retirement/turnover effects. This represents a 3.0 percent increase in education costs.

- *Municipal costs*, including the newly created Facilities Department, increase approximately \$700,000, reflecting employee compensation increases, energy costs, etc. This represents a 1.9 percent increase in municipal costs.

- *"Shared expenses"* comprised of debt service, employee benefits, property and liability insurance, and the operating budget reserve fund, increase approximately \$2.2 million, or 6.7%. \$1.9 million of this increase is driven by an estimated 9 percent growth in employee and retiree health insurance costs.

In the aggregate, the town's expenses are anticipated to rise nearly \$4.6 million (a 3.3 percent increase). Any cost-of-living-increases for public employees (municipal and school) would represent an additional \$800,000 for each percentage-point increase.

Capital spending. The town incurs capital expenses for a range of different purposes, including maintenance of town and school buildings, roads, and facilities; recurring replacement of vehicles and equipment; land acquisition; and renovation and construction of town and school buildings and facilities. And it pays for these expenses through a variety of means, including appropriations of current funds ("cash capital"); within-levy borrowing; exempt borrowing ("debt exclusions"); use of state funds (for example, for school buildings and roads); use of enterprise funds (principally water and sanitary sewer systems, whose users are billed for such services); and use of Community Preservation Act revenues. In recent years, Lexington has authorized \$4 million-\$5 million of capital projects (road repair, building maintenance, drainage systems, fire and emergency equipment, public-works equipment, etc.) annually from the tax levy (including both borrowing and cash within the "general fund" budget). Appendix C, Capital Financing Summary: FY2007 to FY2010, summarizes capital spending in recent years from the various sources of funding.

Note two important issues concerning capital projects:

- First, the town tries to fund a certain share of capital spending, including all of its smaller projects, with cash (averaging \$870,000 from FY2007 to FY2010). The town borrows for larger items with expected longer lifetimes, paying the resulting costs (interest and retirement of principal) within the budget. Such costs compete with other uses of funds for programs and operations *within* the budget.

- Second, large, nonrecurring projects are funded by affirmative public votes on so-called “debt-exclusion overrides,” authorizing borrowing and repayment *outside* the general fund budget. Past examples include the secondary-school renovations, the construction of new Fiske and Harrington elementary schools, major road repairs, and the Department of Public Works headquarters and garage. Among the larger such projects on the horizon are further major road repairs; renovations or replacement of the police and fire headquarters; further school renovations/expansions; and a senior/community center. Portions of some of these projects, and others, may be funded by the Community Preservation Act. *Although such costs fall outside the budget, the aggregate costs are of course borne by Lexington taxpayers.*

Capital spending is already being restrained, both by deferring authorization of pending projects to the future and by deciding to delay projects for which Town Meeting has already authorized funds. In determining how to sustain operating budgets during times of fiscal stringency, past town governments have had to weigh the costs of deferring maintenance to the future (as in incurring more costly road repairs). That issue arises again now, as does the issue of financing some routine maintenance through borrowing, rather than through current budget appropriations of “cash capital.”

Reserves, discretionary actions, and other potentially favorable factors. Lexington’s government—the administration, elected officials (the Selectmen and School Committee), and Town Meeting—have prepared for less favorable financial circumstances by:

- accumulating financial reserve funds in accordance with the town’s fiscal policy, most significantly resulting in a *stabilization fund balance of \$6.8 million* and an additional \$700,000 in a fund for unbudgeted special education costs;

- restraining discretionary capital spending, as noted above; and

- restraining hiring* as vacancies occur.

In addition, as a result of recent legislative action, the town will gain access to a new source of revenue—an estimated \$500,000 annually, beginning in FY 2010—from *applying the property tax to telephone company poles and wires*. The legislature has also given the town *discretion to levy new taxes on restaurant meals and lodging services* (effective later in FY 2010 if enacted by a Special Town Meeting this fall, and estimated to produce \$350,000 and \$145,000, respectively, on an annual basis thereafter).

With regard to the property taxation of telephone company poles and wires, it should also be noted that, depending on the outcome of ongoing litigation, the town at some point may also gain use of some \$600,000 of escrowed funds for prior year taxes. The task force wishes to emphasize that any such one-time revenues should not be spent to support on-going operating expenses. Rather they should be used for such one-time purposes as

replenishing (or reducing utilization of) the stabilization fund or supporting capital purchases.

Longer-term considerations. Whatever decisions are made to resolve any potential gap that may arise in the already-appropriated FY 2010 budget and the currently forecast gap of approximately \$4 million in the FY 2011 budget, there are significant longer-term issues to be weighed at the same time.

Reserve replenishment. As the stabilization fund monies are spent, credible commitments need to be made to *restore* them. In its response to the 2006 Financial Policy Review Committee recommendations, the administration made explicit the importance of “a specification of the number of years to return the fund to its target level when it is drawn down below that level.” (The target balance is approximately 7 percent of general fund revenues—implying, at the current size of Lexington’s government, a stabilization fund of close to \$10 million, and more as the budget itself grows.)

Capital priorities. Looking ahead, several large capital projects are already identified on the town’s agenda (as noted above).

Retiree benefits. In the wake of the FY 2009 decline in financial asset values, the next actuarial valuation of the pension plan assets may require a stepped-up appropriation to put Lexington back on track to full funding of these obligations. In addition, the town had begun to fund its other post-employment benefit obligations (retiree healthcare). Funding of those obligations may need to be budgeted as a regular item in the town’s financial planning horizon.

Policy Context

The major fiscal issues facing Lexington government as we strive to *sustain public services* (municipal and school), *retain the skilled and valued people* who provide those services, and *maintain the physical assets/infrastructure* on which we depend are:

- heightened economic uncertainty*, making it much more difficult to plan sound budgets;

- the likelihood of an immediate *cessation in the growth of revenues during the upcoming fiscal year*, with a possibly prolonged period of depressed state aid thereafter; and

- the *risks that recent decreases in employment and individual wealth will erode residential construction and renovation* (further weakening a principal source of revenue growth in recent years).

Another risk, subject to considerable uncertainty, is *that the present period of extraordinarily low inflation and interest rates may be followed at an unknown time by substantially higher inflation and interest rates*. That would put upward pressure on wage and benefit costs while depressing the housing market. It would also make borrowing for capital projects more expensive.

This task force has been asked by the Selectmen to advise on fiscal policy in the relatively near term. In doing so, we recognize that the need for putting Lexington's financial decisions on a new basis may extend for a protracted period of time. Accordingly, we make recommendations reflecting both the uncertain duration of the current economic challenges and their uncertain severity.

Revenue and Expense Outlook, Fiscal Years 2011-2012 and Beyond

As the Appropriation Committee reported to Lexington Town Meeting this past spring:

While the process of defining our baseline set of assumptions always involves judgment, this year we find that the current global financial crisis and major recession has made it much more difficult. Indeed, we don't know how deep the recession will be, how long it will last, how fast the recovery will be, what its effects on state and town revenues will be, what interest rates will be and how they will change, how the prices of goods and services will change, how the depressed job market will affect wages and salaries, etc. It should therefore be no surprise that in this environment we had trouble not only agreeing with each other on a baseline set of assumptions, but even in coming to individual opinions on what might be reasonable guesses.

Notwithstanding this uncertainty, both the Appropriation Committee scenarios (see Appendix D) and more recent town staff forecasts made available to the task force during May-June 2009 (see Appendices A and B) – both of which assume the maintenance of level services and no bargained-for cost of living increases in employee compensation – suggest *a budget gap of approximately \$4 million*. And, although the town has not yet made budgetary projections for FY 2012, the Appropriation Committee scenarios suggest *an even greater gap for FY 2012 of \$5 million to \$7 million*. As noted, all such forecasts are subject to changes in revenue (state aid, local receipts, new growth) and expenses (principally compensation costs for Lexington employees, including salaries and wages and benefits; as noted above, each percentage-point increase in employee wages adds \$800,000 to the budget). None of these figures reflects actual FY 2009 results nor adjustments in FY 2010 estimates as a result of recent legislative action.

Consistent with our strong conviction that short-term considerations need to be evaluated in the context of Lexington's longer-term financial situation, we also highlight these secular issues:

Health benefits. As reported at the spring Town Meeting, *the sustained double-digit increase in health benefit costs for town employees and retirees has put the entire budget under increasing pressure*. Total compensation costs for town employees, although currently negotiated as two separate elements (income and benefits) within a state legal framework, need to be addressed as a whole. *Slowing the growth in current costs of health-benefit programs and controlling their future inflation are of the highest priority for Lexington's near-term and long-term financial position, for the town's ability to provide valuable services and to compensate its employees fairly, and, ultimately, for the town's ability to fund its employee retirement-benefit obligations.*

Growth in and diversification of the property tax base. Lexington derives 77.9 percent of its property-tax revenue from residential taxpayers, 18.4 percent from commercial and industrial real estate, and 3.7 percent from the taxation of business personal property. In part to expand the commercial tax base and thus reduce the pressures on residential taxpayers (as well as to encourage local job growth, and for other reasons), Town Meeting this year moved to adopt new zoning standards for the Hartwell Avenue commercial-industrial area, which may over a substantial period of time yield additional revenue; and approved the Ledgemont III (Beal) proposal, which was projected to yield

approximately \$500,000 annually per year in net additional tax revenues after construction and occupancy.

At the developer's request, action was not taken on the Patriot Partners proposal to further increase development at Lexington Technology Park. That proposal may come before a Special Town Meeting this fall, as may a subsequent expansion proposal from Cubist Pharmaceuticals.

Such projects, if developed, could contribute to tax revenues later in the coming decade.

Recommendations

The high degree of uncertainty affecting both revenues and expenses in the future makes budgeting especially challenging. Accordingly, our first, overarching recommendation is that *decisions be made, to the greatest extent possible, with a recognition of the uncertainties that Lexington faces*. Fiscal policies must be guided by long-term directions and principles, but *the specific strategies and tactics adopted must evolve with the situation as new information becomes available*.

We begin by planning for FY 2011 with an assumed budget gap of approximately \$4 million. That figure may well be revised, in either direction, depending on:

- the closing balances for FY 2009, which will determine free cash available for the FY 2011 budget;
- the level of spending in FY 2010 (for example, costs for snow and ice removal), which will, in turn, determine the level of free cash available for FY 2012 (and may affect spending estimates for FY 2011);
- decisions affecting employee total compensation (salary and benefits) in FY 2010 and beyond;
- clearer indications about the national and state economies, bearing on the length of the downturn, the pace of recovery, and/or inflation;
- indications about the Commonwealth's plans for local aid, especially Chapter 70 funds, for FY 2011;
- actual data on local receipts (affecting both the year-end FY 2010 balance and the forecast for FY 2011 and beyond); and
- actual experience with residential and commercial "new growth" revenues entering the tax base in each fiscal year.

In that context, *we offer specific recommendations concerning near-term action on expenses and on revenues to cope with the projected FY 2011 budget gap* (with consideration for the likely implications for FY 2012 and beyond); and then *several general recommendations, which apply to all budget years*.

FY 2011 Expenses

Exercising maximum restraint in compensation. We recommend that in the current circumstances—constrained revenues, historically low inflation, but persistent healthcare cost inflation, particularly in the Greater Boston area—*maximum restraint be exercised in the negotiation and setting of total compensation (public-employee salaries and wages, plus benefit costs), from the bargaining units through the executive ranks*. The task force recognizes that very few Lexington citizens and taxpayers will receive salary or wage increases in the coming year, and many will face significant *reductions* in income; this reality provides crucial context for Lexington's compensation decisions. As part of this recommendation, we urge as the highest fiscal priority that *town management and bargaining-unit leadership promptly agree on ways to effect substantial, lasting, and*

pervasive savings in employee healthcare benefit costs. We can envision *no* financial scenario in the near-term future or beyond which enables us to maintain services and our public workforce without such significant changes.

Capital items. Increased use of borrowing to defer an additional portion of capital costs, and perhaps some modest deferrals of capital maintenance, should be considered. As discussed below, the current environment of construction costs and interest rates may favor expanded reliance on borrowing over simple deferral of projects that we know we will have to undertake in the next several years, especially ones whose costs may grow due to postponement. Some members of the task force, however, expressed concerns about the wisdom of either deferring capital maintenance or increasing the level of borrowing to fund such projects as a way to fund on-going operating expenses.

Retirement obligations. Some modest deferrals of funding of the town's long-term obligations to retiree pension and benefit costs may be prudent, although, like utilization of the stabilization fund (see below), such choices may call for additional expenditures during the recovery phase.

Discretionary cost restraint. During FY 2010, both the municipal and the school administrations should continue to take all prudent measures to hold down costs—for instance by deferring the filling of non-critical vacancies and by careful review of all purchases. These measures can help avoid FY 2010 cost overruns, may help secure free cash balances for FY 2012, and may assist in identifying potential budgetary savings for FY 2011.

Early identification of possible cost reductions. Both the schools and the municipal departments need to identify possible areas for reductions in spending for FY 2011. *We recommend that both the schools and the municipal departments be asked to identify possible strategies for cutting the anticipated growth in their respective budgets.* This process should generate a menu of options that could save \$1 million, if needed; this \$1 million target should be equitably allocated between the town and school budgets. We believe that program *reductions* should only be considered to the extent that the other strategies discussed in this report prove insufficient to close the gap. But we also believe that it is important that such *options be identified* and available in case of need. If program cuts become necessary, we recommend prioritizing cuts that would be relatively easy to restore in future years, rather than ones that would entail long-term consequences.

FY 2011 Revenues

Broadening the tax base. Apart from the current circumstances, it has long been a goal of many municipal-finance experts, and officials, to broaden localities' tax bases. In light of recent state legislative action, *we recommend that Lexington take the necessary steps to enact the new local-option user taxes (0.75 percent meals tax, additional 2 percent hotel tax) with the earliest feasible effective date,* and develop revenue estimates for these sources for FY 2011 and beyond. These new revenue sources will help to diversify the town's revenue stream and will provide a badly needed supplement to the existing sources. We believe that the scale of these taxes is such that they are unlikely to affect the vitality or competitiveness of Lexington's businesses.

Grant and stimulus funding. Consistent with good management practice, both the municipal departments and the schools should take all reasonable measures to pursue any

grant funding (particularly from federal economic-stimulus appropriations) that can assist in covering costs of existing programs and services. The task force does not recommend the use of grants to initiate new programs that might require tax levy funding if the grant funding later terminates.

Use of stabilization fund. *We recommend that the town's stabilization fund reserves, accumulated for the purpose of strengthening the town's financial flexibility and avoiding disruption during a period of recession and decline in state financial aid, be drawn from judiciously – not to support new services, positions, facilities, or initiatives (subject to the caveat concerning innovation below), but to help maintain existing municipal and school services and facilities.*

This recommendation is *not* self-implementing. The task force discussed a range of policies for using the stabilization fund to support the FY 2011 budget, mindful of the fact that in the current uncertain fiscal environment, the need for such appropriations may be *larger* in FY 2012 than in FY 2011 (arguing for building in some margin)—but that such a contingency is unknowable at present.

Without settling on a definitive guideline for our recommendation, we felt that based on the information available to the task force as of June 2009, *for FY 2011, Lexington might draw down somewhere between \$2 million and \$3 million from the stabilization fund.* The exact amount will depend on the actual FY 2011 budget gap, to be refined as more information becomes available (as discussed above). In addition, the decision about stabilization fund use for FY 2011 must be informed by evolving information about FY 2010 revenues and expenses, as well as about the fiscal picture for FY 2012. Particularly were the budget gap for FY 2011 to worsen, we could envision a maximum draw of \$3 million in FY 2011. This would still allow for a similar draw from the stabilization fund in FY 2012, while retaining a modest balance beyond that point. *The objective is to attempt to maintain level services during the period of anticipated maximum fiscal stress.*

General Recommendations

The task force anticipates that the preceding list of recommendations—presented in rough order of priority—is likely to provide sufficient tools to address the challenges of the FY 2011 budget. While this same set of strategies should again play a central role in planning for FY 2012, the task force recognizes that for that year and beyond, a broader set of questions remains and a broader range of issues must be considered.

Exercising maximum restraint in compensation. Consistent with the discussion above, for the next several years, maximum restraint in total employee compensation policy will remain critical.

Proposition 2 ½ operating overrides. After the worst of the financial downturn (during which we recommend reliance on use of the stabilization fund and the other measures discussed above)—and *if suitable, structural, effective changes are made that restrain the growth in total compensation costs, it would then be appropriate to ask Lexington voters, through the mechanism of a Proposition 2 ½ operating override, whether they wished to increase taxes to maintain services, or instead to reduce services.* (Consistent with its past fiscal policies, Lexington has recognized that the costs of providing local public services—and property values, and resident incomes—increase over time faster than the tax-levy growth allowed under Proposition 2 ½, and so voters have

periodically been given the opportunity to determine whether to fund services with an operating override. Obviously, the timing of override issues matters; the town would not ordinarily choose to pursue an override during periods of severe financial stress—an important rationale for establishing a stabilization fund or reserve, and for using it in a timely fashion.)

Rebuilding reserves. *We support a policy to rebuild the town's financial reserve funds in a timely fashion* to the level of 7% of general fund revenues, as recommended by the 2006 Financial Policy Review Committee.

Replenishing reserves will be a protracted, difficult challenge, because:

- the reserves we accumulated earlier in this decade did not reach the above-mentioned benchmark of 7% of general fund revenues, given the untimely advent of the credit crisis and recession;
- the reserve accumulation was made easier by several significant, one-time financial events (“windfalls,” if you will; note that the escrowed taxes on poles and wires, discussed above, represents a possible future example of such a windfall); and
- with the growth in the town's budget, it will be desirable to build reserves to a significant level before the next downturn, i.e. to a level probably on the order of \$10 million or more.

The present circumstances underscore the evident wisdom of the town's commitment over the past several years to building a substantial stabilization fund, which will help Lexington weather the effects of the current economic downturn, while surrounding communities, and others throughout the Commonwealth, are slashing services and laying off experienced, valued members of their workforces. We hope our fellow townspeople will recognize the value of this important accomplishment, and will embrace an ongoing policy of establishing, drawing down, and renewing reserve funds—even though implementing it implies a multiyear period of discipline, sacrifice, and restraint. This policy may necessitate appropriating money into the stabilization fund even in years when other operating expenses are contingent on a Proposition 2 ½ override.

Service restructuring and innovation. This report has made much of the imperative of finding a better, more cost-effective way to provide employees with health benefits. By the same token, we want to encourage the restructuring of programs to enhance efficiency, realize cost-savings, and improve service to the public. As noted, recent examples of successful program innovations that meet demanding cost criteria include investments in in-house special-education programs and in building energy conservation. The thresholds for such investments must be rigorous, but the town is ill-served if we leave *no* room for continuous improvement through application of information technology, adoption of best practices, consolidation or regionalization of service delivery, etc.

Preservation of services. Our premise is that we want to *avoid* reducing services through prudent use of the various strategies discussed above. Lexington public policy has long been driven by a commitment to give residents a voice in determining whether services are to be maintained or reduced, when financial circumstances dictate, through the Proposition 2 ½ override mechanism. We endorse continuation of this approach.

Remaining Long-Term Issues for Further Discussion

Other pressing issues will determine whether Lexington's present menu of services is sustainable over the long term. To date, the task force has had only limited opportunities to consider these issues:

Major capital projects. Major projects envisioned within the next half decade are estimated to cost at least several tens of millions of dollars. Prioritization and timing of the principal ones—police and fire headquarters, road reconstruction and repair, school renovation/capacity expansion, and perhaps a senior/community center—would present a pressing and daunting challenge even in more favorable budgetary circumstances.

While the task force considered these issues at some length, their complexity prevented us from reaching consensus on what advice to offer. We were also aware that significant additional information about a number of these potential projects will be available in the near future, particularly through the report of the school department's Ad Hoc Facility Committee which is expected in the fall.

There was a general sense that particular focus should be placed in the near term on instances where deferred maintenance would represent, in effect, an inappropriate deferral to the future of what will surely be higher mandatory costs (such as for repair of further-deteriorated roads), and where the case can fairly be made to the public that acting promptly is cost-effective and appropriate, as part of the overall objective of maintaining essential community services and assets. But the task force did not arrive at conclusions concerning how rapidly such projects should be advanced, nor on how the town should prioritize the full range of major capital projects that have been discussed.

Community Preservation Act (CPA). The CPA, adopted by Lexington voters in 2005, levies a 3 percent surcharge on property-tax bills to pay for affordable housing, historic preservation, and open space/recreation projects, as defined by law. The funds raised locally are matched by the state—initially at 100 percent, and currently at about 33 percent. The CPA levy itself currently raises about \$3.1 million annually. The existence of those funds has enabled the community to take advantage of unusual opportunities—this past spring, to purchase two parcels for open space, at a cost of \$7 million—which under other circumstances likely could not have been funded in a timely fashion.

The task force held several discussions about the appropriate and desirable range of uses of CPA funds and the place of this levy in the town's overall fiscal picture. But, in light of the complexity of the issues, the range of reasonable perspectives, and the limited time and information available to the task force, we are not in a position to offer recommendations concerning the CPA revenues at this time, beyond the admonition that the CPA funds represent an important town resource that should be carefully and effectively deployed where reasonable and appropriate.

Long-term compensation policy. While the short-term approach toward total employee compensation must be one of maximum restraint, with a particular emphasis on reining in growth in health-benefit costs, the task force recognizes that the longer-term issues are more multi-faceted. This is another area in which we held some fruitful discussions but did not have sufficient information nor time to frame specific

recommendations. Our discussions did recognize the possible value of further research and analysis relating to the operation of our health benefit programs. In addition, we recognize the need, over the longer term, to strike an appropriate balance between fiscal restraint and ensuring the continuing competitiveness of the total compensation that we offer to town and school employees.


Program restructuring. In order to preserve services and facilities while maintaining fiscal discipline, it is essential that the town and schools aggressively pursue opportunities that will allow for more efficient program operation. This will require ongoing attention to opportunities for restructuring, consolidation, and regionalization. This is a topic that the task force only had the occasion to discuss briefly. We did not have the opportunity to seriously consider how the town can best ensure that these opportunities are being fully identified and explored.

The state legislative agenda. As Lexington Town Meeting, the Selectmen, the town manager, and others have indicated, this community and other Commonwealth localities have asked the legislature for reforms that would facilitate more efficient, cost-effective operation of municipal government. The rules for negotiating employee compensation, particularly benefits, are one significant example. The task force has not had an opportunity to review specific proposals for legislative reform, in this area or in others, but recognizes that this is an important area for further analysis and discussion.

Appendix A

Historical and Projected Revenues: FY07 to FY11									
General Fund Revenue Summary	FY2007 Budget	FY2008 Budget ²	FY 2009 Budget ³	FY 2010 Budget ⁴	Projected FY2011 Budget	Percent Change			
						FY07- FY08	FY08- FY09	FY09- FY10	FY10- FY11
Property Tax Levy ¹	\$ 96,010,528	\$ 104,833,786	\$ 110,778,389	\$ 115,447,848	\$ 118,718,083	9.19%	5.67%	4.22%	2.8%
State Aid	\$ 8,304,953	\$ 9,064,275	\$ 9,777,583	\$ 9,018,027	\$ 9,018,027	9.14%	7.87%	-7.77%	0.0%
Local Receipts	\$ 10,448,000	\$ 9,123,000	\$ 9,395,065	\$ 9,770,000	\$ 9,250,930	-12.68%	2.98%	3.99%	-5.3%
Available Funds	\$ 4,923,000	\$ 4,216,097	\$ 5,620,168	\$ 6,053,619	\$ 3,317,000	-14.36%	33.30%	7.71%	-45.2%
Revenue Offsets	\$ (1,530,137)	\$ (1,897,006)	\$ (2,540,476)	\$ (1,832,471)	\$ (2,011,887)	23.98%	33.92%	-27.87%	9.8%
Enterprise Receipts	\$ 1,772,313	\$ 1,752,885	\$ 1,710,887	\$ 1,662,522	\$ 1,617,705	-1.10%	-2.40%	-2.83%	-2.7%
Gross General Fund Revenues	\$ 119,928,657	\$ 127,093,037	\$ 134,741,615	\$ 140,119,545	\$ 139,909,858	5.97%	6.02%	3.99%	-0.1%
Component of Property Tax Levy Attributable to New Growth ⁵	\$ 2,036,789	\$ 2,485,650	\$ 3,276,649	\$ 1,900,000	\$ 1,500,000				
Unreserved Fund Balance (free cash) Certifications ⁶	\$ 5,409,985	\$ 3,802,347	\$ 4,861,516	\$ 5,481,716	\$ 2,500,000				
Stabilization Fund Balance ⁷	\$ 1,568,013	\$ 4,281,554	\$ 5,484,443	\$ 6,687,409	NA				
¹ Property tax levy does not include revenue raised outside the "levy limit" to finance capital projects approved by voters. FY2009 and subsequent years reflect revenue from the taxation of poles and wires. FY2009 revenue attributable to poles and wires is set aside in the overlay account which is a component of Revenue Offsets.									
² Growth in levy limit includes \$3.98 million operating budget override voted in June, 2007									
³ State aid reflects Governor's mid-year "9C reduction" of \$185,570.									
⁴ State Aid reflects final state budget.									
⁵ FY2010 is estimated and FY2011 is projected									
⁶ Certification as of the July 1st prior to the start of the fiscal year. For example, the amount shown for FY07 is the certification as of July 1, 2005.									
⁷ As of the beginning of the fiscal year									

Appendix B



Town of Lexington

FY2011 Expenditure Projection

The methodology utilized in this projection is a maintenance budget approach; that is, the projected increase in costs needed to maintain the "current level of services" reflected in the adopted FY10 budget. As a general rule, it only includes increases driven by estimated inflationary pressures, current collective bargaining agreements and other existing purchase of service contracts.

	FY 2009 Budget	FY 2010 Budget	FY 2011 Projected	\$ Difference	Notes
Education					
LPS Wages	\$ 54,407,961	\$ 55,926,576	\$ 57,604,373	\$ 1,677,797	Assumes 3% annually for step increases. Can vary based on staff turnover.
LPS Expenses	\$ 10,140,228	\$ 11,031,717	\$ 11,362,669	\$ 330,952	Assumes average of 3% inc. for Cont. Serv, Transp. & Supplies
Minuteman	\$ 1,510,598	\$ 1,711,554	\$ 1,882,709	\$ 171,155	Assumes 10% growth annually
Municipal					
Municipal Wages	\$ 21,603,439	\$ 22,418,061	\$ 22,709,495	\$ 291,435	Includes all municipal salaries, salary adjustment account and Public Facilities salaries. FY2010-2012 assumes 1.3% annual increase for steps applied to FY09 base.
Municipal Expenses	\$ 12,362,588	\$ 12,971,658	\$ 13,360,808	\$ 389,150	Includes all municipal and Facilities Department expenses. Assumes 3% inc. for Cont. Serv, Transp. & Supplies including fuel.
Shared Expenses					
Debt Service	\$ 4,017,541	\$ 4,471,432	\$ 4,593,139	\$ 121,707	Actual debt service on authorized and issued debt and estimated debt service on authorized and unissued debt.
Retirement	\$ 3,488,236	\$ 3,685,396	\$ 3,823,302	\$ 137,906	Contrib. & Non-Contrib (contrib per actuary's assessment schedule as of 6/30/08)
Benefits	\$ 22,140,749	\$ 22,874,458	\$ 24,814,042	\$ 1,939,584	9% inc. in health, 5% inc. in Medicare, level-funded dental & life
Reserve Fund	\$ 532,500	\$ 550,000	\$ 600,000	\$ 50,000	\$50,000 annual increase until reaching FPC recommendation of 1/2 of 1% of G.F. revenues
Workers Compensation	\$ 306,625	\$ 351,625	\$ 376,239	\$ 24,614	Average 7% increase annually
Unemployment	\$ 100,000	\$ 267,300	\$ 100,000	\$ (167,300)	Level-Funded at FY09 budget
Property & Lib. Insurance	\$ 608,240	\$ 611,497	\$ 672,647	\$ 61,150	Projected increase of 10% in FY2011
Uninsured Losses	\$ 138,402	\$ 100,000	\$ 125,000	\$ 25,000	Increase of \$25K annually to build loss reserve
Capital	\$ 1,520,750	\$ 1,545,719	\$ 1,563,112	\$ 17,393	Includes 2.5% increase to annual road and building envelope set-aside and \$850,000 for cash capital
Reserves	\$ 1,000,000	\$ -	\$ -	\$ -	No set-aside into reserves projected.
Other	\$ 519,000	\$ 950,690	\$ 445,000	\$ (505,690)	FY09 includes \$50,000 for Brookhaven, \$45,000 for senior tax work-off program, \$400,000 for OPEB and \$24,000 for trees. FY2010 includes \$45,000 for senior tax work off; \$350,000 for SPED reserve; \$440,690 for OPEB; \$15,000 for tourism promotion; and \$100,000 for planning consulting services. FY2011 projection is \$400,000 for continued funding of OPEB liability per FPC recommendation and \$45,000 for tax work-off program.
Total Expenses	\$ 134,396,857	\$ 139,467,683	\$ 144,032,535	\$ 4,564,852	
Variable Cost Drivers					
		Municipal Wages	\$ 227,000	Annual cost of every 1% of COLA increase	
		School Wages	\$ 576,000	Annual cost of every 1% of COLA increase	
		New Debt Service	\$ 45,000	Estimated FY2011 short-term debt service on \$1 million of authorizations. \$1 million in authorizations will translate into approximately \$145,000 in long-term debt service in FY2012.	
Notes:					
Debt Service does NOT include Exempt Debt					

Appendix C

Capital Financing Summary: FY2007 to FY2010						
	FY07	FY08	FY09	FY10		
General Fund Debt-Financed	\$ 4,603,000	\$ 4,867,700	\$ 5,678,360	\$ 3,126,223		
Cash Capital ¹	\$ 990,000	\$ 655,000	\$ 872,000	\$ 961,000		
Tax Levy-Financed ²	\$ 960,000	\$ 1,350,000	\$ 1,378,750	\$ 1,395,719		
Enterprise Fund Debt-Financed ³	\$ 1,700,000	\$ 3,363,520	\$ 3,100,000	\$ 2,582,500		
Community Preservation Fund ⁴	\$ 320,000	\$ 859,295	\$ 956,900	\$ 1,069,000		
Subtotal	\$ 8,573,000	\$ 11,095,515	\$ 11,986,000	\$ 9,134,442		
Exempt Capital ⁵	\$ -	\$ 25,180,000	\$ -	\$ -		
Total	\$ 8,573,000	\$ 36,275,515	\$ 11,986,000	\$ 9,134,442		
¹ Includes capital financed from general fund unreserved fund balance, other available funds and enterprise fund retained earnings						
² Includes annual allocation of Chapter 90 funds for road improvements to supplement road improvement funding from the tax levy						
³ Water, Sewer and Recreation Enterprise Funds						
⁴ Includes Town projects only.						
⁵ Projects voted as debt exclusions to be funded outside the limits of Proposition 2 1/2						

Exhibit E

Ad Hoc Fiscal Task Force

Members: 7 to 11 members
Appointed by: Selectmen
Length of Term: Preliminary recommendations to Selectmen by July 1st
Final Report by September 15th.
Appointments Made: As Needed
Meeting Times: one evening per week in May and June (day to be determined)

Description: To evaluate the Town's likely financial scenario for the FY2010 to FY 2014 period, identify options for dealing with these challenges and recommend policies and actions to maintain stable and vibrant Town services when financially feasible.

The work of the Task Force will include, but not be limited to:

1. Identifying the potential significant changes to the Town's revenue base/financial condition resulting from the current economic downturn;
2. Assessing the potential length of the current downturn as it applies to the Town's financial condition; and
3. Propose options for addressing the impact of the recession on the Town's ability to fund services, including:
 - service reduction or elimination,
 - use of reserves, and
 - changes in the capital plan.

Criteria for Membership: The Task Force members shall consist of fiscally inclined citizens, with sufficient background to anticipate the future financial and political landscape.

Composition: Selectmen (2), School Committee (1), TMMA (1) and citizens (up to 7). Staff support will be provided by the Town Manager, Assistant Town Manager for Finance and Budget Officer. The School Superintendent or his designee shall be a non-voting member.

Ref.: Charge adopted by the Selectmen on April 15, 2009. Members designated as Special Municipal Employees on April 15, 2009.

Members:

Peter Enrich, Chairman	Paul Asquith	Charles Benson
George Burnell	Thomas Diaz	Andrew Friedlich
Catherine Gill	Jeanne Krieger	Joseph Rancatore
John Rosenberg	Herbert Wasserman	

Liaisons:

Alan Levine, John Bartenstein, Appropriation Committee

Charles Lamb, Capital Expenditures Committee

Staff:

Rob Addleson, Comptroller, Micah Niemy, Budget Officer, Carl Valente, Town Manager
Denise Casey, HR Director, Paul Ash, Superintendent of Schools, Maryellen Dunn, Assistant Superintendent