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# Federal Solitude, Local Costs:

## The Impact of Federal Regulation on Municipal Finances

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**T**HERE HAS BEEN growing attention in recent years to the financial burdens imposed on business by federal regulation. Popular resistance to rising local taxes, dramatized by the success of California's Proposition 13 two years ago, has also received a steady stream of publicity. Yet remarkably little attention has been given to the mounting costs that federal regulation now imposes on local governments—even though these costs are, in many cases, a significant element in the heavy revenue demands of those governments. While the federal government is prohibited under the Constitution from imposing direct taxes on state and local governments, it has been able to force them, like private industry, to shoulder the costs of complying with a wide variety of federal requirements adopted in pursuit of national objectives. And, like private businesses, *Thomas Muller is a principal research associate, and Michael Fix a research associate, of The Urban Institute.*

local governments must either cut existing operations or find some way to pass these costs along.

One way for local officials to accomplish the latter, apart from increasing local taxes, is of course to seek further financial assistance from the federal government itself. Indeed, the publicity routinely accorded federal grants to local governments—always welcome to politicians at both levels—has probably been a major factor in obscuring the size of federally imposed *costs* from the attention of local taxpayers. That is not to say that federal aid to local governments has been insubstantial. Direct federal grants to cities rose from \$1.3 billion in 1970 (equal to 9.6 percent of total local taxes) to \$10.2 billion in 1978 (equal to 37 percent of total local taxes).

These figures, impressive as they are, may be misleading, however, because many grants come with regulatory strings attached, others with hidden costs—and such assistance can end

up, at least in raw dollars, costing cities more than it brings in. The fact is, that despite the dramatic increase in overall federal contributions to local treasuries, the sums many cities must spend to comply with federal regulatory requirements can absorb a substantial share of the total funds they receive under various federal programs.

Yet generalizations in this area must be guarded. While federal grant outlays are easy enough to compute, the costs of complying with regulatory requirements are always difficult to determine, and especially so in this area where circumstances (and therefore cost effects) vary markedly from city to city. To set the problem in more concrete terms, we undertook last year, on behalf of the Joint Economic Committee of Congress,<sup>1</sup> a detailed study of compliance costs for a limited sample of communities and a select number of federal regulations. Of the hundreds of existing federal mandates that affect local expenditures, we focused our attention on six major programs, chosen primarily because local officials had described them to us as notably expensive or intrusive. The programs were: the Clean Water Act Amendments of 1972 and 1977, the 1976 Amendments to the Unemployment Insurance Compensation Act, bilingual education requirements (under the 1974 Bilingual Education Act and the 1964 Civil Rights Act), the Education of All Handicapped Children Act, transit accessibility requirements for the handicapped (under the Rehabilitation Act of 1973), and the Davis-Bacon Act. Our sample of seven jurisdictions was selected to include communities from all parts of the country, varying in population (from 39,000 to 848,000 as it turned out) and also varying widely in per capita income and local tax burdens. The seven were: Alexandria, Virginia; Burlington, Vermont; Cincinnati, Ohio; Dallas, Texas; Fairfax County, Virginia; Newark, New Jersey; and Seattle, Washington.

The figures we present here were gathered from inspection of local agency records and from interviews with local officials. As we were more concerned with reliability than completeness in cost estimates, we limited our calculations to the incremental costs of local compliance, and typically did not factor in administrative or overhead costs, or allow for the costs associated with secondary economic effects—all of which would have been quite

difficult to quantify. Thus our figures generally *understate* the total compliance costs associated with these six regulatory programs.

To determine incremental costs, we identified all direct local expenditures under our six programs that would not have been incurred in the absence of the federal requirements. In other words, where existing local programs overlapped with federal requirements, we counted as "costs" only the proportion of total outlays that exceeded the level considered necessary by local officials. Thus if local engineers believed secondary treatment of waste water to be sufficient to meet health and environmental objectives, but tertiary treatment was required by federal standards, only the differential between the two would be identified as an incremental cost. Similarly, if prior to the promulgation of federal standards, a local school district was already providing its handicapped students with educational services and if these were later acknowledged by federal officials as sufficient to meet the standards, we would find no incremental cost.

#### Accounting for Costs

The overall costs that these programs imposed on our sample of jurisdictions were substantial. As Table 1 indicates, incremental operating costs under five of our six programs totaled \$51.9 million in 1978, or \$19 for every resident of the seven jurisdictions.<sup>2</sup> In addition, the in-

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cremental capital costs incurred by the seven jurisdictions, shown in Table 2, totaled \$113.5 million. When capital outlays were amortized over a twenty-year period at 8 percent interest

<sup>1</sup> The data in this article are based, in part, on a report that the authors prepared for the Joint Economic Committee of Congress.

<sup>2</sup> The costs associated with the Davis-Bacon Act are not included in the tables because those costs are difficult to cumulate.

and added to operating costs, total locally funded incremental costs ranged from \$6 per capita in Burlington to \$52 per capita in Newark. The average across the seven jurisdictions was \$25 per capita.

One statistic can put the figures in Tables 1 and 2 into sharp perspective: the aid that the seven jurisdictions received under federal revenue sharing averaged about \$25 per capita a year—essentially the same as what it cost them, on average, to comply with these regulatory programs. (Revenue sharing is designed to relieve revenue strains on state and local government by providing federal contributions that local governments can freely devote to their own needs and priorities, rather than those mandated by the federal government.) There was substantial individual variation within the sample, it is true, with local compliance expenditures ranging from 20 percent of revenue-sharing receipts in Burlington to 129 percent in Newark. Still, in a typical jurisdiction all funds obtained through revenue sharing were fully consumed by the costs of complying with these five federal requirements alone. One may wonder, of course, whether this surprising situation is truly typical of U.S. cities, given the wide variation in costs within even our small sample. But because the sample was reasonably representative, we have no reason to believe that a larger sample would show a different overall pattern.

As for the other side of the cost-benefit equation, the incremental benefits secured by these regulatory programs are, in the nature of things, virtually impossible to quantify. It is worth noting, however, that in contrast to most business regulation, these regulatory programs are designed to benefit their own regulatory targets—the cities themselves, or at least the residents of the cities. They require local governments to provide services or benefits that parallel or supplement (where they

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do not entirely overlap) services or benefits already being provided. The incremental costs of these programs, then, generally reflect expenditures that the local governments *might* have made on their own, but have not, in fact,

**Table 1**  
INCREMENTAL LOCAL OPERATING COSTS, 1978  
(in \$ thousands)

Jurisdiction	Clean Water Act	Unemployment Compensation	Bilingual Education	Education for the Handicapped	Transit Access for the Handicapped	Total	Per Capita
Alexandria	\$1,600	\$ 97	(NP)	\$1,000	(NA)	\$2,697	\$24.74
Burlington	0	35	(NP)	65	43	143	3.67
Cincinnati	5,000	350	(NP)	0	400	5,750	13.78
Dallas	4,100	40	381	1,628	0	6,149	7.59
Fairfax County	4,100	120	500 <sup>a</sup>	12,080	(NA)	16,800	31.64
Newark	10,400	60	2,300	2,150	(NA)	14,910	45.14
Seattle	2,300	225	1,000	1,800	100	5,425	11.05
Total	27,500	927	4,181	18,723	543	51,874	18.97 <sup>b</sup>

NA—not available, NP—no program.

<sup>a</sup> Incremental costs of increased recordkeeping needed to demonstrate adequacy of English as a second language program. <sup>b</sup> Average.

**Table 2**  
INCREMENTAL LOCAL CAPITAL OUTLAYS  
(in \$ thousands)

Jurisdiction	Clean Water Act	Unemployment Compensation	Bilingual Education	Education for the Handicapped	Transit Access for the Handicapped	Total	Per Capita	
							Total	Annually <sup>a</sup>
Alexandria	\$ 6,800	—	—	\$ 25	\$ 102	\$ 6,927	\$66.60	\$6.80
Burlington	0	—	—	700	0	700	17.94	1.83
Cincinnati	13,000	—	—	0	7,140	20,140	49.98	5.10
Dallas	12,300	—	—	2,500	14	14,814	17.53	1.79
Fairfax County	30,200	—	—	1,197	1,700	33,097	57.65	5.88
Newark	20,700	—	—	1,700	2,960	25,360	75.88	7.74
Seattle	12,100	—	—	200	150	12,450	25.45	2.60
Total	95,100	—	—	6,322	12,066	113,488	44.43 <sup>b</sup>	4.53 <sup>b</sup>

<sup>a</sup> Amortized over twenty years at 8 percent interest. <sup>b</sup> Average.

wished to make. Thus from the local perspective, at least, virtually all of the incremental costs associated with these programs must have exceeded the perceived benefits—else the programs would have been undertaken without a mandate from Washington. From a national perspective, of course, the perceived benefits may still justify the investment, but this does not make it any easier for local jurisdictions to swallow the costs involved.

### Varying Burdens

The variation in individual cost burdens is a matter of considerable interest in itself, whatever the overall cost average may suggest. We had not anticipated such sizable divergence when we began our study—nor, we suspect, did Congress when it enacted these particular requirements. Nonetheless, it is plain that significant inequities, or at least incongruities, in the distribution of these regulatory costs do exist. And when one looks more closely at any of these programs—at how they generate local costs and at the sources of the cost variations—it seems clear that such effects could scarcely have been avoided.

*The Clean Water Act.* The Clean Water Act, by far the most expensive of our six federal programs, sets minimum discharge standards for municipal waste-water treatment plants. Prior construction activity played an important role in determining the incremental costs of these federal standards for the different cities in our sample. In Burlington, Vermont, for example, the fact that an advanced sewage treatment plant had been built before enactment of the 1972 Clean Water Act Amendments meant that the incremental costs of the new federal standards were low. Indeed, increased federal involvement worked to Burlington's advantage, making the city eligible for more federal financial support than had been available previously. Cities that had not seen the necessity for sophisticated waste-water treatment plants before 1972 (whether from differing geographic and economic circumstances or differing local attitudes) naturally found the new federal standards more costly.

*Unemployment compensation.* Under the 1976 amendments to the Unemployment Com-

pensation Act of 1974, state and local governments were required to finance unemployment insurance coverage for their employees, if they wanted private employers in the state or locality to continue receiving federal tax credits for unemployment compensation payments. By this measure, Congress was able to shift the burden of claims payment from the federal budget, where it had rested for two years, to state and local budgets.

In 1978 and 1979, the costs of this program to local governments were lower than expected, because employment opportunities in the private sector were expanding and fiscal conditions in many of the nation's cities were improving. However, if the current recession deepens and leads to widespread layoffs in both private and public employment, the costs of paying unemployment insurance claims to government workers could be quite substantial. Yet national economic trends rarely have the same effect on all parts of the country. As unemployment patterns vary, so too, of course, will the cost impact of unemployment compensation. Ironically, then, under the current scheme, the cities and counties that are poorer or are suffering greater economic dislocation will have to bear heavier costs in this area than the more affluent or more economically stable jurisdictions.

*Bilingual education.* Current federal law directs that all school districts offer formal bilingual education training to any group of twenty or more students who speak the same foreign language. The impact of this requirement is dictated in large part by the demographic make-up of a community, which, in turn, largely corresponds to geographic location. Port and border cities, such as Newark and Dallas, have large non-English speaking populations which require expensive bilingual programs. By contrast, cities lying further inland tend to have more homogeneous populations and therefore do not incur comparable costs.

Another variable accounting for some of the variation in incremental costs in this area is the willingness of local officials to comply with federal standards. Political will is, of course, as much a matter of public (or official) attitudes as of fiscal constraints. The refusal, for example, of Fairfax County, an affluent

suburb of Washington, D.C., to follow the bilingual education guidelines of the Department of Health and Human Services (HHS) results in part from opposition to the social and educational theory they imply. In addition, the county notes that its students come from fifty different language backgrounds, fifteen of which are spoken by more than twenty students. Were it to follow the HHS guidelines, the county would incur the expense of sponsoring bilingual programs in fifteen different languages, including Urdu, Hindi, and Laotian.

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Continuing legal and illegal immigration can be expected to increase substantially the costs of providing bilingual education in coming years. At the same time, many cities will face overall declines in public school enrollment, even with an influx of new immigrants, so that in their cases the proportion of overall costs consumed by bilingual programs will also grow.

*Education for the handicapped.* The 1976 Education of All Handicapped Children Act required, among other things, that school districts identify all unserved handicapped children, that all handicapped children from ages three to twenty-one be given a "free, appropriate" education, and that handicapped students be educated with nonhandicapped students to the maximum extent appropriate. This program is now the most rapidly rising category of public expenditure in the nation. In Fairfax County, Virginia, for example, outlays for handicapped education have increased three times faster than outlays for other school services since the enactment of federal legislation.

Here, as in other program areas, the amount of activity undertaken in advance of federal regulation was a prime determinant of local incremental costs. Cincinnati, for example, already had an existing program for handicapped children that was well enough developed to meet new requirements. By contrast,

Dallas had only a skeletal program in place, so that costs soared after promulgation of federal standards.

*Access to public transit for the handicapped.* The requirement that public mass transportation facilities—bus stops, train stations, and rail and bus services—be made accessible to the handicapped derives primarily from Section 504 of the Rehabilitation Act of 1973. Our inquiry was confined to the costs arising under federal standards of April 1976, which called upon local governments for "special efforts" to meet the needs of the handicapped, among other things, by making at least half of their bus fleets wheelchair-accessible. Jurisdictions that were not due to replace a large proportion of their operating fleet were likely to incur much higher expenses, since it is much more expensive to retrofit existing buses with wheelchair lifts than to purchase new buses having lifts incorporated into the original design. (For a general survey of the new and more costly regulations issued in May 1979, see "Regulation Gone Amok" by Timothy Clark, *Regulation*, March/April 1980.)

*The Davis-Bacon Act.* The local burdens imposed by this act, under which the Department of Labor sets minimum wage scales for federally subsidized projects, were significant in several of the jurisdictions studied. In Vermont, for example, Davis-Bacon wages for carpenters were 16.4 percent higher than carpenters' wages on nonfederal work, and in Dallas the difference between Davis-Bacon pay scales and locally established wages averaged 20 percent. In the case of this program, the variation in incremental costs is largely attributable to the strength and political leverage of local labor unions. Thus, for three of our cities located in states where the unionized proportion of the labor force is larger than the national average, we found that prevailing wage levels in construction were high, so that Davis-Bacon requirements imposed little added cost. But in states where the unionized proportion of the labor force is relatively small, such as Texas and Vermont, the effect of the act was found to be pronounced.

*The fiscal context.* Even where the incremental costs of a program (by our method of

calculation) appear to be roughly comparable for two cities, the actual fiscal impact of those costs may be significantly different. Some cities receive matching funds from their state governments for certain projects (construction of waste-water treatment plants, for example) or benefit from offsetting state contributions in other areas. Similarly, some cities have a broad and healthy tax base, allowing them to cover increased costs with only slight increases in local tax rates. On the other hand, cities with less generous or reliable revenue sources (or greater cost burdens in other areas, resulting for example from a larger number of welfare recipients) may find that the same federally imposed costs present a far more dangerous or difficult fiscal strain.

### Hidden Costs

The importance of assessing the regulatory burdens imposed on state and local government is starting to be recognized within the federal government. The Committee on the Budget of the House of Representatives, for example, recently recommended that all House committees (except Appropriations) include with all new bills an estimate of the potential cost impacts on state and local governments. But trying to project in advance the costs of new regulatory requirements can be very difficult. Beyond the problems stemming from the great variation in impacts from one city to another, programs often have hidden costs that are easily overlooked at the outset. In our own

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limited study, we encountered more than a few of these hidden costs or unanticipated perverse effects.

*Induced demand.* Programs that heavily subsidize the construction of new facilities, whether a limited-access highway or a treat-

ment plant, can result in inefficiencies by stimulating excessive engineering and overcapacity. This comes about because local governments, whose contribution to construction costs is relatively small, have no short-run incentive to economize at the beginning of the project. Following the construction, they will frequently channel development into the neighboring area so as to absorb the excess capacity created and thus to justify the capital investment. Moreover, the presence of the new facility can induce additional demand.

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The same is true of a new public service. For example, the number of children designated as handicapped grew substantially after federal legislation was passed, and their parents are now asking for even more comprehensive educational services. Indeed, it appears that the parents of handicapped children have increasingly come to regard these specialized services as strict entitlements rather than as merely desirable benefits. Expansion of earlier programs has sparked litigation in many areas by parents demanding yet wider expansion of services. Thus, cost projections made at the time that the requirements are initially formulated tend to be unrealistically low because they almost necessarily underestimate total demand.

*Operating costs.* It is essential that programs having a large capital component, such as the Clean Water Act and Section 504 of the 1973 Rehabilitation Act, explicitly take into account long-term operating and maintenance costs. Many a community, for example, has built an advanced sewage treatment facility with large federal contributions, without identifying at the outset the ongoing nonreimbursable costs it will have to bear. Yet these have now proved to be very heavy indeed, in part because such a large portion of operating expenses relate to energy and labor costs—both of which, of course, have soared in recent

years. Thus, in Dallas, operating costs for the local water treatment facilities rose from \$1.3 million in 1975 to \$8.7 million in 1978—363 percent in just four years. Yet while the capital costs of this program and others like it are heavily subsidized by the federal government (up to 85 percent of costs), no federal reimbursement is available for operating and maintenance expenses.

*Price effects.* Federal as well as local planners also need to recognize that certain federal directives will stimulate demand for a product or service, producing significant price effects. When large amounts of federal aid become available for a particular program, the prices of the associated goods and services will rise to reflect the increased demand. And since the goods and services are needed for programs that are mandated by, and often heavily subsidized by, the federal government, the price increases will effectively reduce the amount that available funds can buy without reducing total demand.<sup>3</sup> This pattern applies to a broad spectrum of goods and services, including sewage treatment equipment and health-care services. For example, between 1972 and 1978, when federal aid for medical care expanded from \$23 billion to \$54 billion, medical care prices increased by 66 percent, considerably more than other services. Thus, over two-thirds of the additional \$31 billion in aid was absorbed by price increases. In situations of this kind, funds set aside for state matching purposes shrink, putting localities in the unexpected position of having to absorb a higher share of total outlays.

*Local conditions.* Federal planners can too easily overlook differences in local conditions when enacting general standards. For example, using the lift design for the handicapped was not feasible in Burlington, Vermont, because of local weather conditions. A standard that can only be functional for a few months each year is obviously questionable, but national standards do not always provide appropriate exceptions. Where such special circumstances do not impose higher costs, they may still *seem* more burdensome to the localities involved, because

<sup>3</sup> Where program costs are federally subsidized, price increases would have to exceed the perceived local value of the subsidy for demand to fall.

the accompanying benefits are so evidently limited.

### Reimbursement: Who Should Pay?

The present system of reimbursement for locally incurred costs is almost as haphazard as the distribution of regulatory costs themselves. Congress cannot begin to sort through the current tangles, however, until it establishes a clearer set of priorities among regulatory objectives. A few elementary distinctions may help in the first steps of this sorting.

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In the first place, it is useful to distinguish federal requirements that are compulsory from those that are conditions of assistance and thus, at least in theory, elective. Federal mandates that order local governments to engage in or refrain from certain actions are obviously the most restrictive form of regulation. Relatively rare because of the constitutional and legal problems they impose, such mandates bind state and local governments in much the same way that traffic laws bind individual citizens. The Clean Water Act, for example, *requires* municipal waste-water plants to meet certain minimal discharge standards, regardless of how the plants are financed. Where congressional goals are so pressing or critical as to justify a mandatory requirement, they may also be crucial enough to deserve federal subsidy, particularly if the cost of the requirement is substantial. The common sense of public policy dictates that the federal government should not leave local governments with a financial incentive to noncompliance.

Far more common than direct and unconditional mandates are requirements that are formulated as conditions for receiving federal assistance. Even within this category, however, certain further distinctions must be observed. Some regulatory programs set extensive and complex conditions that local governments

must meet to receive any federal funds, regardless of the immediate aim or purpose of the particular funding arrangements involved. Standards developed under the 1973 Rehabilitation Act, for example, require architectural modification for wheelchair accessibility (through ramps, elevators and so on) for any local "program"—mass transit, education, recreational services, and so on—which receives any "federal financial assistance." Similarly, Title VI of the 1964 Civil Rights Act prohibits discrimination "on the basis of race, color or national origin" in all programs receiving federal financial assistance, and it is from this statute (under the "national origin" category) that bilingual education requirements have been imposed on all school districts receiving federal aid of any kind. While local governments can theoretically avoid the costs of complying with such requirements simply by refusing all federal aid, that is a nearly impossible recourse, in practical terms, for most cities. Yet the cost of compliance with these overarching requirements bears no relation to the number or size of the grants that trigger their operation. If such requirements are not to defeat the purpose of particular federal grants (by forcing massive diversion of local programs), the larger costs involved ought to be reimbursed. On the other hand, if the purpose of the federal requirement is to support a judicially declared constitutional entitlement—perhaps in response to local denial of that entitlement or inaction—then the claims of cities and counties for federal reimbursement are not compelling.

Nonreimbursement of regulatory costs is most easily justified where local costs represent the front-end costs of obtaining federal subsidies for discrete programs or projects. One example would be the requirement that cities provide matching grants to demonstrate proper levels of commitment to federally subsidized efforts. Another would be local governments' obligation to pay Davis-Bacon wages as a simple quid pro quo for federal construction grants. In each case, unrelated federal projects and programs would remain unburdened by federal conditions.

This basic division of regulatory costs must still accommodate certain exceptions and qualifications, however. Conditional subsidies for particular projects may be generally legiti-

mate, but they obviously are counterproductive where they incorporate perverse incentives for expensive, overcapacity construction—as sometimes happens with federal subsidies to waste-treatment plants. On the other hand, the continuation of tax subsidies as a quid pro quo for local participation in efforts aimed at easing municipal financial distress makes little sense if the cost of complying with subsidy conditions mounts in direct proportion to financial distress within the recipient city. This is, as we have seen, what will happen with the Unemployment Insurance Compensation Act Amend-

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ments of 1976. In cases of this sort, where the costs of compliance are inversely related to the ability to pay, there is need for a reimbursement formula that takes varying fiscal capacity into account. Finally, reimbursement should be made available when localities experience rapid demographic and environmental changes that significantly expand the burden of earlier federal requirements. A particularly vivid example of this is the sudden arrival of thousands of Cuban refugees to Miami, triggering a mandatory expansion in the city's bilingual education programs. The rationale for federal reimbursement in such cases is evident.

THE SUGGESTIONS WE HAVE OFFERED are only a beginning, of course. Yet if even these rough guidelines had been acknowledged prior to the imposition of the regulatory programs examined here, the programs would certainly have emerged with different substantive requirements and different funding strategies than they did. In the last decade, Congress has often enacted extensive requirements for local governments with too little thought for the costs involved. Now that the bills are coming due—and proving to be substantial—Congress will have to give more attention to how they are paid. ■