

**IN THIS ISSUE**

**Comparing utility shutoffs and mortgage foreclosures reveals much to learn for utility industry (part 2 of 3)**

**NOTE TO READERS**

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**ASSESSMENT OF THE COSTS OF  
DISCONNECTIONS FOR NONPAYMENT  
SHOULD CONSIDER EXTERNAL  
("OUTSIDER") IMPACTS**

When utilities seek to justify their use of involuntary disconnections for nonpayment, they generally focus exclusively on the short-term impact of whether a particular bill remains outstanding. A recent study by Fisher, Sheehan & Colton comparing and contrasting utility shutoffs with mortgage foreclosures reveals that the utility industry approach does not capture the full economic costs of a utility service shutoff. Whether involving water service or energy (natural gas, electricity) service, costs external to the utility itself (i.e., "outsider costs") should also be considered.

FSC's comparison found that foreclosures cost everyone money. In assessing the returns to the industry based only on differing collection strategies, mortgage holders consider the Net Present Value (NPV) they will receive with and without mortgage interventions. Many industry stakeholders, however, recognize that "even if loss mitigation were granted whenever it was NPV-positive, the NPV test would still not take into account society's interest in preventing abandoned homes and the negative spillover effects that result from them."<sup>1</sup> It is to these outsider costs, therefore, that we next turn.

<sup>1</sup> Patricia McCoy. (August 2013) *The Home Mortgage Foreclosure Crisis: Lessons Learned*. Joint Center for Housing Studies, at 34, 36. Harvard University, Cambridge (MA). (hereinafter, *Lessons Learned*).

## The Policy Significance of “Outsider” Costs In the Mortgage Industry.

Efficient decision-making is pursued only if “all the expected risks and costs are reflected in the pricing of the deal.”<sup>2</sup> The problem posed by failing to consider the outsider costs of mortgage collections is that “local taxpayers and area residents are forced to shoulder burdens that are rightfully the responsibility of borrowers, mortgage lenders and others that are direct parties to the transaction.”<sup>3</sup>

When these direct parties do not bear the full economic costs of their transaction, there is a misallocation of societal resources.<sup>4</sup> If external costs are not considered, instead of identifying preventable foreclosures, mortgage servicers will pursue activities which maximize their immediate financial returns “only to later leave behind a host of costs that are ultimately paid by municipalities, neighboring homeowners and businesses, and other mortgage entities invested in the neighborhoods where these loans go bad.”<sup>5</sup>

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<sup>2</sup> William Apgar, Mark Duda and Rochelle Nawrocki Gorey. (February 27, 2005). *The Municipal Cost of Foreclosures: A Chicago Case Study*, at 2, 3. Homeownership Preservation Foundation, Minneapolis (MN). (hereinafter, “Municipal Cost of Foreclosure”).

<sup>3</sup> *Id.*, at 2, 3.

<sup>4</sup> “Even if loss mitigation were granted whenever it was NPV-positive, the NPV test would still not take into account society’s interest in preventing abandoned homes and the negative spillover effects that result from them.” G. Thomas Kingsley, Robin Smith and David Price. (May 2009). *The Impacts of Foreclosures on Families and Communities*, at 34. The Urban Institute, Washington D.C. (hereinafter, “Impacts of Foreclosures on Families and Communities”).

<sup>5</sup> *Municipal Cost of Foreclosure*, supra, at 3; see also, William Apgar and Mark Duda. (May 11, 2005). *Collateral Damage: The Municipal Impact of*

The failure to consider external costs is significant because when the costs of a mortgage foreclosure are borne by external parties, there is no incentive for the parties to the initial transaction to seek alternatives that would prevent or mitigate those costs. The parties involved with the foreclosures pursue their own best interests “while leaving others to pick up a portion of the costs generated when loans go bad.”<sup>6</sup>

Economists define the hurt that a foreclosure can place on neighbors as a “negative externality” whose cost is not considered by the mortgage recipient or mortgage holder when deciding whether foreclosure is the appropriate course of action. Using a simple benefit cost assessment of whether a residential property should go into foreclosure, foreclosure rationally occurs if the benefits to the private parties involved exceed their private costs. The private parties in the foreclosure decision ignore the additional public cost that a foreclosure can impose upon neighboring properties. If such an external cost is present, a greater than economically optimal number of homes will enter foreclosure.<sup>7</sup>

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*Today’s Mortgage Foreclosure Boom*, at 4, Homeownership Preservation Foundation, Minneapolis (MN). (hereinafter, “Collateral Damage”) (“... anyone invested in nearby homes and businesses stands to lose if a rash of foreclosures brings down property prices, accelerating the decline of an entire neighborhood. Along with local agencies, it is these area homeowners, business owners, landlords and other investors who shoulder a burden that rightfully belongs to the parties directly involved in the failed mortgage.”)

<sup>6</sup> *Collateral Damage*, supra, at 4.

<sup>7</sup> Robert Wassmer (March 2011). *The recent 7 external effects of residential home foreclosure.*

There are, in other words, “too many unnecessary foreclosures [that] occur[...], inflicting needless, widespread losses not only on homeowners and investors, but also on surrounding communities in the form of depressed housing values, shrinking tax bases, crime and neighborhood decay.”<sup>8</sup>

To correct for these market failures, there is significant opinion that when the harm of a collection activity such as a mortgage foreclosure falls on an external party, policymakers should consider those external harms when deciding on how to prevent or mitigate the underlying problems.<sup>9</sup> For example, policymakers should:

consider not only any benefits or costs that might accrue to the lenders or borrowers who are directly involved, but also the significant costs of foreclosures borne by communities. . .[W]hen a certain outcome is shown to hurt parties external to the transaction, the arguments for policy intervention and for more direct policy intervention (e.g., limiting or outlawing certain practices versus simply requiring disclosure) become even more robust.<sup>10</sup>

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Housing Policy Debate 21(2):247-265, at 248, 263. (hereinafter “Pervasive External Effects”).

<sup>8</sup> Impacts of Foreclosures on Families and Communities, *supra*, at 36.

<sup>9</sup> “. . . if the magnitude of this negative externality is large enough, micro-economic theory suggests a role for government in getting the private parties to internalize this public cost into the private parties’ decision to foreclose upon a mortgage.” Pervasive External Effects, *supra*, at 248.

<sup>10</sup> Dan Immergluck and Geoff Smith. (2006). The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values. Housing Policy Debate 17(1):57-79, at 75. (hereinafter, “Impact on Property Values”).

Two ways exist to address the adverse public harms that are not considered by entities who seek to foreclose on unpaid mortgages. On the one hand, the external costs can be internalized to the private parties through charges to prevent or mitigate the public harms. On the other hand, those activities creating the harms can be directly regulated or outright prohibited. As one commentator notes:

[S]imple fairness dictates that where a lender (or anyone else) takes actions that impose significant social and economic costs on innocent third parties, be they neighboring homeowners or local governments, they should not get a free ride at a cost to the public—they should bear the burden of those costs, which are known as externalities. This is why for many decades now environmental laws have been in place that bar companies from polluting the air and water, and require them to bear the cost of cleaning them up where they do so.

Second, making commercial entities absorb the external costs of their business behavior is not only fair, but is a good way to encourage those entities to behave in ways that do not impose such costs on society. If debt collection by foreclosure becomes more expensive—and if the parties initiating the foreclosure actions become aware of the full costs associated with their actions—alternatives to foreclosure that, in the final analysis are likely to be in the interest of both lender and borrower, will become more attractive.<sup>11</sup>

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<sup>11</sup> Allan Mallach (June 2009). Addressing Ohio’s Foreclosure Crisis: Taking the Next Steps, at 9. Metropolitan Policy Program at Brookings Institution, Washington D.C. (hereinafter, “Ohio’s Foreclosure Crisis”).

In those instances where there is an external public cost of a collection activity, which will not ordinarily be taken into account by the business engaging in the collection activity, public control of the action, either in terms of directly barring the activity, or in terms of imposing costs on the industry either to prevent or to mitigate the external harms, or in terms of imposing a charge that internalizes the external costs, is merited even if such public responses impose a burden on the industry.<sup>12</sup>

### **Identifying the Full Economic Costs of Foreclosures.**

The economic costs generally taken into account in deciding whether to pursue a mortgage foreclosure are only “internal” costs. Internal costs include those costs directly incurred by the industry,<sup>13</sup> including but not necessarily limited to legal fees, court costs, lost payments, maintenance costs, and lost value between the resale value of the foreclosed home and the value of any outstanding principal. In contrast, however, there are also substantial external economic costs associated with the decision to foreclose. The servicers which bill and collect mortgage payments do not take the full economic costs of their activities into account.<sup>14</sup>

While the section immediately above discussed the policy significance of the presence of external costs, this section will begin to identify and define what some of the major components of those external costs are. The Brookings Institution notes that “as foreclosures increase, a series of effects, sometimes referred to as the

secondary effects of foreclosure, become visible.”<sup>15</sup> The secondary effects Brookings identified include, but are not limited to, a “deterioration and loss of value of the property being foreclosed” and a “diminution of the value of surrounding properties; the more foreclosures in the immediate vicinity, the greater the loss of value.”<sup>16</sup> Moreover, Brookings found, “foreclosures destabilize neighborhood economic and social conditions.”<sup>17</sup> Another commentator observes:

When homeowners experience foreclosure, the outcome not only affects households and lenders but can also pose significant negative externalities on communities and state and local governments. . . .The disruption can also lead to housing displacement or homelessness, economic shocks such as impaired credit, untenable work situations, and significant stress, affecting family relationships. . . .In neighborhoods and communities, foreclosures drag down property values, lead to abandoned and unkempt properties, and raise crime rates, factors that increase the risk of more foreclosures. The effects on state and local governments are far reaching as well, and include lost revenues from a shrinking property tax base, growth in demand for services for displaced families, plus police and fire protection for abandoned properties, and potentially significant pressures on court systems—squeezing budgets on both the revenue and spending sides.<sup>18</sup>

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<sup>12</sup> Ohio’s Foreclosure Crisis, *supra*, at 9.

<sup>13</sup> For purposes here, references to “the industry” need not distinguish between whether the decision to foreclose is exercised by the financial institution originating the loan or by a third party servicer. No distinction will be made between different stakeholders in the financial service industry.

<sup>14</sup> Collateral Damage, *supra*, at 5 - 7.

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<sup>15</sup> Ohio’s Foreclosure Crisis, *supra*, at 3.

<sup>16</sup> *Id.*, at 3.

<sup>17</sup> *Id.*

<sup>18</sup> Robert Clifford. (September 2011). State Foreclosure Prevention Efforts in New England: Mediation and Assistance, at 2-6. Federal Reserve Bank of Boston, Boston (MA). (citations omitted).

Perhaps the most studied impact of foreclosures involves the impact on surrounding property values. A discussion of this external impact is presented in the May-June 2020 issue of FSC's Law and Economics Insights.

### ***Place-based Impacts.***

Neighborhoods and surrounding communities represent one of the primary stakeholders that bear external costs associated with mortgage foreclosures. Foreclosures have been found to destabilize entire neighborhoods.<sup>19</sup> Neighborhoods (as well as broader communities) have “reputations” that are placed at risk by the foreclosure of properties. “Just like companies and individuals,” one researcher notes, “municipalities care about their reputation. To the extent that the growth of foreclosures and resulting vacancies undermine the attractiveness of particular neighborhoods, the municipality may gain a reputation as not being a good place to live and work – a negative image that may extend well into the future.”<sup>20</sup>

Some neighborhoods and communities are known for their good neighborhood parks or excellent school systems. These neighborhood attributes are known as “amenities.” In contrast, the presence of a foreclosure is seen as a neighborhood “disamenity.” “Disamenity effects are a source of the negative impacts of foreclosures on their neighbors . . . [F]oreclosed properties do have a negative externality on nearby property values due to its disamenity

effects. . .”<sup>21</sup> As has been found, “the mere presence of a foreclosed home might diminish the desirability of a neighborhood.”<sup>22</sup> Those neighborhoods having substantial numbers of foreclosures “face additional social stigma,” making it difficult for residents to refinance or to sell their homes.<sup>23</sup>

These impacts are “place-based”<sup>24</sup> rather than household-based. One place-based impact of foreclosures, for example, involves how reduced child care<sup>25</sup> further affects a neighborhood. “Another casualty of the foreclosure crisis has been in the realm of licensed home-based child-care businesses, particularly in low-income and minority neighborhoods. . . . The diminishing supply of child care in low-income and minority neighborhoods will pose a challenge to working parents and to job-seekers, and may further dampen the economic recovery in these

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(hereinafter, *State Foreclosure Prevention Efforts in New England*).

<sup>19</sup> Cost Effectiveness of Mortgage Foreclosure Prevention, *supra*, at 4, 8.

<sup>20</sup> Municipal Cost of Foreclosure, *supra*, at 10, 12; see also, Cost Effectiveness of Mortgage Foreclosure Prevention, *supra*, at 4 (negative image of neighborhood results in decline in property values).

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<sup>21</sup> Xian Bak and Geoffrey Hewings. (undated). *Measuring Foreclosure Impact Mitigation: Evidence from the Neighborhood Stabilization Program in Chicago*, at 1, 4. Regional Economics Applications Laboratory, University of Illinois, Urbana (IL). (hereinafter, “*Measuring Foreclosure Impact Mitigation*”).

<sup>22</sup> Daniel Hartley. (October 27, 2010). *The Impact of Foreclosures on the Housing Market*. Economic Commentary, at 2. Federal Reserve Bank of Cleveland, Cleveland (OH). (hereinafter, “*Impact of Foreclosures on Housing Market*”).

<sup>23</sup> Anne Martin. (December 9, 2010). *After Foreclosure: The Displacement Crisis and the Social and Spatial Reproduction of Inequality*, at 6. Institute for the Study of Social Change, Department of City and Regional Planning, University of California, Berkeley, Berkeley (CA). (hereinafter, “*The Displacement Crisis*”).

<sup>24</sup> *The Displacement Crisis*, *supra*, at 7.

<sup>25</sup> Danne Davis and Minsun Shin. (2009). *The Lives of Sesame Street: the impact of foreclosures on young children and families*. *Contemporary Issues in Early Childhood* 10(2):182-184, at 183. (hereinafter, “*Lives of Sesame Street*”).

neighborhoods.”<sup>26</sup> Another example of place-based adverse impacts involves social relationships. The departure of families due to foreclosure “may pull apart the social fabric that may otherwise be available to new residents.”<sup>27</sup> The significance of place-based impacts is that these “effects of foreclosure continue to impact the neighborhoods households leave behind. . .”<sup>28</sup>

The neighborhood reputation impacts identified above adversely affect far more than the households living in near proximity to a foreclosed property. The loss of neighborhood reputation also affects neighborhood business owners and employees. As neighborhoods decline, customers more frequently choose not to shop in the local businesses serving those neighborhoods,<sup>29</sup> resulting in reduced profitability of the business.<sup>30</sup> It makes it more difficult for local area employees to attract workers.<sup>31</sup> By extension, these impacts adversely affect the municipal government not only through the lost property taxes associated with lower housing values, but also through lost municipal sales and income taxes as well.<sup>32</sup>

### ***Household-Based Impacts.***

The place-based impacts identified above differ in-kind from the adverse economic impacts that are incurred by individual households. One of the most evident impacts on households facing the foreclosure of their mortgage involves the

“reputation costs” which they incur in the future. Reputation costs encompass those costs associated with the “stigma associated with default.”<sup>33</sup> For example, these increased household costs include the increased future borrowing costs associated with reduced credit ratings,<sup>34</sup> as well as future difficulties in finding affordable rental housing.<sup>35</sup>

Out-of-pocket expenses to the defaulting household also represent economic costs associated with foreclosures. One example of out-of-pocket expenses involves the moving expenses when households are forced to vacate their homes.<sup>36</sup> In addition, any deterioration in a household’s foreclosure status is associated with reduced earnings and increased material hardship.<sup>37</sup> As researchers have found, this increase in material hardship often creates “the familiar self-worsening ‘downward spiral’ at worst, or ‘holding pattern’ at best.” The spiral sees increasing foreclosure rates “causing low growth and [un]employment, causing yet more default and foreclosure, and so on.”<sup>38</sup>

By their nature, foreclosures almost always force affected homeowners to leave their homes. In turn, forced moves have universally been found to have an adverse impact on the affected

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<sup>26</sup> The Displacement Crisis, supra, at 15

<sup>27</sup> Id.

<sup>28</sup> Id., at 7.

<sup>29</sup> Municipal Cost of Foreclosure, supra, at 10, 28, 56; Collateral Damage, supra, at 5.

<sup>30</sup> Municipal Cost of Foreclosure, supra, at 11; see also, Collateral Damage, supra, at 5 (local businesses may see weaker sales).

<sup>31</sup> Municipal Cost of Foreclosure, supra, at 28, 56.

<sup>32</sup> Collateral Damage, supra, at 7 (municipal sales and income tax receipts suffer).

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<sup>33</sup> Loss Given Default, supra, at 14.

<sup>34</sup> Id.

<sup>35</sup> Impacts of Foreclosures on Families and Communities, supra, at 9.

<sup>36</sup> Regulatory Impact Analysis, supra, at 2.

<sup>37</sup> Laryssa Mykyta. (April 30, 2015). Housing Crisis and Family Well-being: Examining the Effects of Foreclosure on Families, at 17 U.S. Census Bureau, Washington D.C. (hereinafter, “Housing Crisis and Family Well-Being”).

<sup>38</sup> Richard Vague and Robert Hockett (April 2013). Debt, Deflation and Debacle: Of Private Debt Write-Down and Public Recovery, at 25. Cornell Law Faculty Publications, Cornell Law School, Ithaca (NY) (citations omitted).

children.<sup>39</sup> “Studies show that when families with children enter foreclosure, the children are more likely to suffer in school and develop behavioral and health issues.”<sup>40</sup> Adverse educational impacts arise for children in the foreclosed homes due to the “instability in their academic environment.”<sup>41</sup> Just as importantly, however, in addition to the impact on children who are forced to move, “the instability in the academic environment extends to families who stay in their homes in foreclosure-impacted communities, as increased turnover in schools can reduce the learning and performance of all students. . .”<sup>42</sup>

The forced mobility associated with mortgage foreclosures has also been found to adversely affect the health of the involved households beyond the children. One study found that increases in foreclosure rates were associated with an increase in unscheduled hospital visits, even after controlling for other possible explanatory factors, while another study found that individuals experiencing foreclosure were more likely to forego health care.<sup>43</sup> Deteriorated health outcomes were reported for households facing foreclosures.<sup>44</sup>

Overall, the research is reasonably conclusive that changes in foreclosure status are associated with a decrease in economic well-being and

increased hardships for the affected household.<sup>45</sup> Moreover, research has shown that mass displacement of households, whether due to public planning decisions (e.g., urban renewal), natural disasters, or market forces (e.g., gentrification) have tended to “silently reshape neighborhoods” and “reproduce inequalities of class, race, gender and age.”<sup>46</sup> As shown in the discussion above, displacement due to foreclosures causes similar impacts.

### **Foreclosure Lessons Applicable to Utility Disconnections**

The learning which has occurred in the mortgage industry, time and again, would provide lessons for the utility industry as well. Overall, as learned with foreclosures, if external costs are not considered, instead of identifying preventable utility disconnections, utilities will pursue activities which maximize their immediate financial returns, only to leave behind a host of costs that are ultimately paid by municipalities, neighboring homeowners, and other businesses that have invested in the neighborhoods where disconnections occur.

When a utility disconnects service, it pursues its own best interests while leaving others to pick up a portion of the costs generated when the utility accounts are disconnected. Utilities ignore these additional public cost that a disconnection of can impose upon neighboring properties. When such external costs are present, a greater than economically optimal number of utility customers will have their accounts disconnected.

Utility disconnections can lead to housing displacement or homelessness. It leads to

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<sup>39</sup> Lives of Sesame Street, supra, at 182-184.

<sup>40</sup> Guiding Principles, supra, at 4 (citations omitted); see also, Housing Crisis and Family Well-Being, supra, at 1, 4.

<sup>41</sup> The Displacement Crisis, supra, at 17.

<sup>42</sup> The Displacement Crisis, supra, at 17.

<sup>43</sup> Housing Crisis and Family Well-Being, supra, at 3 (citations omitted).

<sup>44</sup> Pollack and Comer (2012). Health status of people undergoing foreclosure in the Philadelphia region. American Journal of Public Health 99:1833-1839; Currie and Tekin (2011). Is the foreclosure crisis making us sick? National Bureau of Economic Research Working Paper w17310..

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<sup>45</sup> Housing Crisis and Family Well-Being, supra, at 19; see generally, Impacts of Foreclosures on Families and Communities, supra.

<sup>46</sup> The Displacement Crisis, supra, at 1, 2, 3.

economic stress such as impaired credit, reduced incomes, increased household costs, and disrupted work situations. In neighborhoods and communities, disconnections drag down property values and lead to abandoned properties. As a result, local governments experience lost revenue from a shrinking property tax base, growth in demand for services for displaced families, and police and fire protection for abandoned properties.

Utility disconnections are frequently associated with frequent mobility on the part of the affected customer. In turn, frequent mobility is generally associated with adverse educational outcomes not only for the children who move, but for the students in the schools which the frequently mobile students enter.

Overall, just as with foreclosures, utility disconnections are not only associated with a decrease in the economic well-being, and increase in hardships, for the affected households, but are also associated with adverse impacts to neighborhoods, communities and schools.

### **Summary**

For a complete copy of the FSC paper “Responding to Water Unaffordability in Detroit: Lessons from the Mortgage Foreclosure Crisis,” contact:

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Fisher, Sheehan and Colton, Public Finance and General Economics (FSC) provides economic, financial and regulatory consulting. The areas in which *FSC* has worked include energy law and economics, fair housing, affordable housing development, local planning and zoning, energy efficiency planning, community economic development, poverty and telecommunications policy, regulatory economics, and public welfare policy.