Nobody's home: MIT economist measures how much foreclosures lower housing prices

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Foreclosed homes dot the American landscape — they make up about one in 12 houses with under $1 million left on the mortgage. These foreclosures drive down home prices, both because they add to the housing supply and because the financial firms that acquire the houses want to unload them promptly.

However, since foreclosures often occur in economically struggling areas, it is hard to determine how much of the drop in a home's value is due to its foreclosure, and how much can be blamed on the economy in general.

Now, in a recent working paper, MIT economist Parag Pathak and two Harvard researchers, John Y. Campbell and Stefano Giglio, have put a price tag on foreclosures. Specifically, they've determined how much a foreclosure dents a home's value, as opposed to a home going on the market because the owner has died or declared bankruptcy. Moreover, they've demonstrated how much foreclosures depress the prices of the houses around them, a finding that should capture the attention of home-owners and policy-makers.

In the study, "Forced Sales and House Prices," which will be published in the American Economic Review, Pathak, Campbell and Giglio examined 1.8 million home sales in Massachusetts from 1987 to 2009. By looking in granular detail at real-estate prices, the researchers have concluded that a foreclosure reduces the value of a house by 27 percent, on average.

"It's not surprising that there is a discount due to foreclosure," says Pathak. "But it is surprising that it's so large."

By contrast, other types of forced sales lower home prices by smaller amounts. When a house is sold after the death of an owner, Pathak and his co-authors found, the price drops 5 to 7 percent on average. When an owner declares bankruptcy, the value sinks 3 percent.

The researchers believe that their discovery of the gaps between these various price reductions is a key to isolating the effects of foreclosures. Because the declines in value are so disparate, yet occur among comparable homes in the same times and places, the reductions in value are not all attributable to the same overarching economic conditions. Instead, the researchers suggest in the paper, a central cause of the larger foreclosure discount is that the condition of foreclosed houses often deteriorates much more than it does for other kinds of houses whose ownership changes hands.

Lower benchmarks

This tendency of foreclosed homes to fall into disrepair lies behind the other main finding of Pathak, Campbell and Giglio: The presence of a foreclosed house in a neighborhood reduces the value of the homes around it. In their estimation, the value of a home drops by 1 percent, on average, if it is within roughly 250 feet of a foreclosed home. This paper represents the first time economists have been able to cleanly quantify how much nearby foreclosures affect prices of inhabited homes.

"This can happen for multiple reasons," says Pathak. First of all, he notes, "If you live near a foreclosed house, it may not be maintained." Neighborhood appearances enhance real-estate value, and ill-maintained houses make an area less desirable.

Secondly, even without visible deterioration of foreclosed houses, such homes, when resold quickly for a discount, can affect neighborhood values. “A home-buyer’s benchmark [for a fair price] will usually include houses in the same neighborhood,” Pathak says. Therefore, average local values can sink even without visible blight.

The study is a “very valuable and important paper,” says Christopher Mayer PhD ’93, a professor and dean at Columbia Business School in New York, who thinks it will open up more research on whether foreclosures cause other foreclosures, a process he calls “contagion.” Even though Pathak, Campbell and Giglio found that foreclosures only dent the values of neighboring homes, Mayer questions whether there may be a tipping point “at which a neighborhood starts to fall apart.”

The Obama administration has weighed a variety of proposals aimed at limiting foreclosures. In June, the White House directed $1.5 billion of a newly created “Hardest Hit Fund” to help homeowners in five states — Arizona, California, Florida, Michigan and Nevada — suffering from high numbers of foreclosures.

Pathak believes that there are housing-policy implications to the emerging understanding of the precise impact of foreclosures on neighboring home values. The work, he says, “speaks to whether or not we should have policies to prevent foreclosures. This is a fundamental issue in the housing market, so we’re trying to take a step in the direction of measuring how big a deal this effect is.”

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