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## The Property Market, Affordability and the Malaysian National Housing Policy

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# **THE PROPERTY MARKET, AFFORDABILITY AND THE MALAYSIAN NATIONAL HOUSING POLICY<sup>1</sup>**

by Carmelo Ferlito

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## **Introduction**

The present paper is a follow-up analysis in light of my previously released study on the Malaysian property market (Ferlito, 2018a). The debate has evolved, and it is mainly focused on the issue of housing affordability, judged primarily by the use of the price/income ratio, which is a very limited instrument. In this paper I reaffirm the necessity of tackling the affordability issue in the realm of the general property market situation, which in the current scenario is facing a downturn readjustment process.

The first section of the present work summarizes my previous findings and extends them, taking into account last year's evolution. In section 2 I critically discuss the approach to affordability and analyse the recently released national housing policy. In section 3 policy recommendations are presented, both with reference to the downturn phase of the property market and to the issue of affordability, with special attention to the possibility offered by the rental market. Section 4 concludes the paper.

## **1. An introductory look at the Malaysian property market**

In Ferlito (2018a, 2018b) I analysed the evolution of the property market in Malaysia over the past ten years and observed how positive profit expectations ignited a boom, generating an important wave of investments and transactions in the housing industry; this wave was further propagated by credit expansion. It was observed that in 2012-2013 the expansion reached its peak and was followed by a period of stabilization, while recent indicators suggest the tide reversed its course.

At the same time, the emergence of imbalances in the property market was analysed. In fact, investors focused on high-end properties, leaving unexploited profit opportunities in the affordable housing segment, which is characterized by a high degree of involvement of government agencies. My analysis suggested that the coming downturn should be faced with the will of structural reforms aiming to redefine the credit market and to restore household balance sheets. Such reforms should be accompanied by a shift toward consumption taxes, rather than income taxes, fiscal discipline and monetary certainty, together with the removal of barriers for new business opportunities.

Regarding the affordable housing market, my work argued that a gradual government step back could drive private initiatives toward a partially unexploited segment, achieving the double goal of increasing the number of available affordable housing solutions and helping private investors restructure their capital in light of the downturn.

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<sup>1</sup> I would like to thank Sanford Ikeda, Alain Bertaud and Stephen Malpezzi for their valuable suggestions and the useful research material provided. I would also like to thank Ali Salman and Laurence Todd for their constant support and Adli Amirullah for his research assistance. The usual caveat applies.

Since the time of my previous work on this topic, Malaysia has experienced a radical change in its political framework, and the new Pakatan Harapan coalition is now fully in power. The political block led by former Prime Minister Dr Mahathir included the promise for a radical approach to affordable housing in the pre-election manifesto, and the new government has often declared its intention to tackle the issue. While nothing very radical was included in the 2019 budget, in the past months the government has moved in two directions: on one hand it has issued a new National Housing Policy (NHP), on the other it keeps pushing for the plan of building one million affordable housing units in the next ten years.

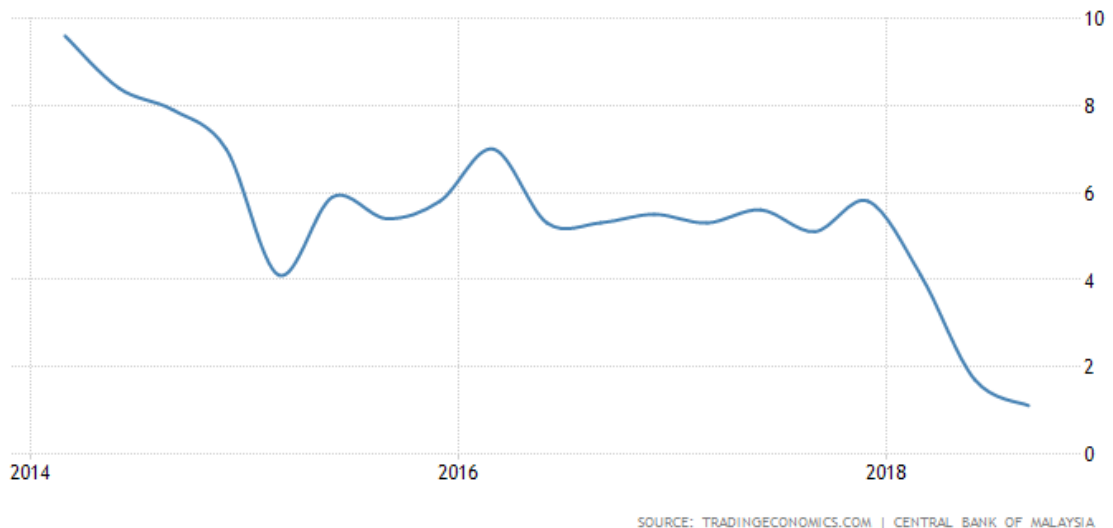
I do not intend here to re-explore the development of the property industry in Malaysia over the past decade; however, it is important to re-stress some of the main findings from Ferlito (2018a, 2018b) and to move from there in order to see what is new in the present scenario and how the government's actions should be judged in light of the most recent developments.

First of all, I remain convinced that the debate on affordable housing is incomplete if it is not contextualized in the realm of the general evolution of the property market. I believe that the discussion is strongly unbalanced toward the issue of affordability, while the property market's cyclical dynamic is disregarded; such a tendency could lead to a situation in which the country will not be equipped to face the consequences of the downturn that has already started.

It is well known that housing fluctuations often lead to business cycles (Malpezzi, 2014, p. 1). As I recalled in Ferlito (2018a, p. 5), the close connection between housing market behaviour and general economic crises must be noted; for the American economy, Gjerstad and Smith (2014, pp. 268-269) have found that most of the twelve smaller recessions between the Great Depression and the Great Recession were preceded by declines in housing investment. Housing decline is a consistently superior indicator of both the duration and the depth of recession than declines in firms' fixed investments. To accurately study the behaviour of the property market therefore means keeping an attentive eye on the possibility of more global economic turmoil.

The downturn in the property market is attested by the most recent evolution in price dynamics; while Ferlito (2018a, p. 9) observed that since 2014 prices continued to increase, although at a slower pace, and since 2016 the pace has been constantly oscillating around 5%, the most recent data demonstrates a further deceleration: the housing price index in Malaysia decreased to 1.10 percent in the third quarter of 2018 from 1.70 percent in the second quarter of 2018.

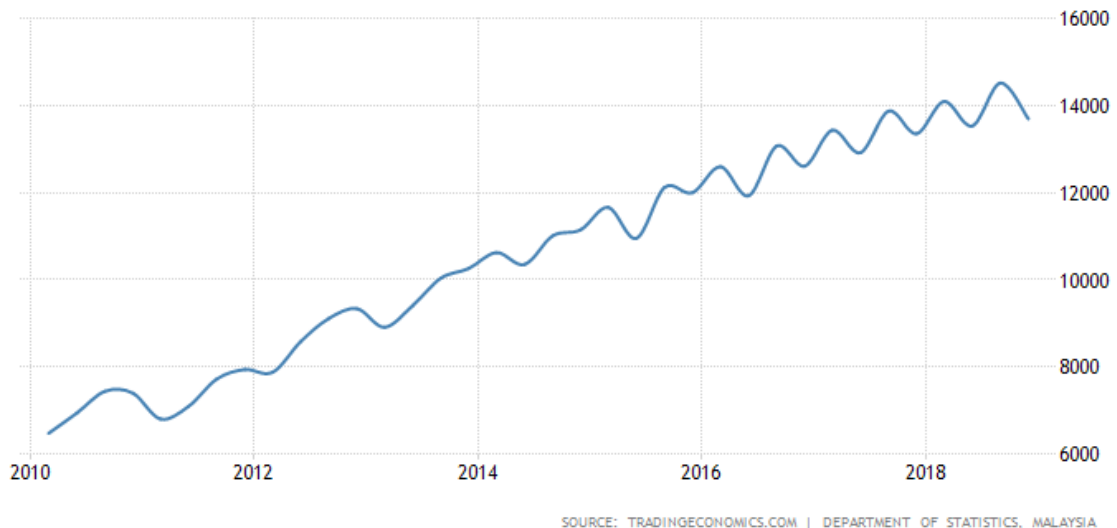
Figure 1: Malaysia Housing Price Index – 2014-2019.



Source: Tradingeconomics.com.

Figure 1 shows how housing prices have been moving at a slow pace since 2018, contributing significantly to the general slowdown of Malaysian prices. The price dynamics are consistent with the growing number of unsold units. «The property market is facing a 48.35 per cent increase in unsold completed residential units as of September 30 compared to the same period last year. *The Star* reported that there are 30,115 unsold units worth RM19.54 billion (up by 56.44 per cent) compared to 20,304 unsold units worth RM12.49 billion last year. Based on a report by the Valuation and Property Services Department (JPPH), the overhang value rises to RM27.38 billion for 40,916 units if serviced apartments and small offices home offices (SoHos) are included in the final tally. The units go across the price range from RM50,000 or less to houses costing more than RM1 million» (Annuar, 2018). At the same time, the data is consistent with the announcement from Rehda about developers' commitment to give a 10 per cent discount on new transactions. In fact, while we experience a market downturn and an issue with affordability, letting the crisis run its course is the best way to get prices to cool down, facilitating a reconciliation between supply and demand. At the same time, the construction sector contribution to GDP seems to be growing in a more unstable way (figure 2) and is experiencing narrower and deeper oscillations.

Figure 2: Malaysia GDP from Construction – 2010-2019.



Source: Tradingeconomics.com.

Such considerations, moreover, drive us to say that the actual policy focus should move from affordability toward facing the downturn and the increasing difficulties of the property market. I will discuss this in section 3.1.

While the economic discourse, even in popular newspapers, seems to be aware of the worrying situation facing the industry, the policy debate on housing is almost entirely absorbed by the issue of affordability. I will discuss the issue of affordability with reference to the Malaysian case in section 2.2. Here it is enough to mention that, on one hand, the new government has been busy developing a new housing policy, which does not appear revolutionary, and I say this with a positive emphasis. In fact, the new housing policy is mainly focused on the attempt to rationalize data collection, a step that could be useful in the partnership between institutions and private developers and in defining the new framework regarding liveability standards. Such a limited scope of action is welcome, and it might allow the market to better work toward developing rational solutions to the current problems. There are, however, some exceptions, which I will mention in sections 2.2 and 3.2, mainly related to the definition of too-rigid parameters for new affordable projects, which may create supply-side bottlenecks and therefore move precisely against the target they intend to achieve.

On the other hand, even if the plan is not stated in the new national housing policy, the government still seems concerned with building one million affordable housing units in the next ten years, a measure which I strongly tend to discourage (the reason why is explained below).

Moreover, as mentioned below, in the attempt to ‘do something’, governments often disregard the fact that affordability is a judgement based on three factors: floor area, location and price per square meter. I should add, following what I argued in Ferlito (2018a, pp. 22-23), that direct government intervention in the low-end property market crowds out potential private initiatives, which may be useful in the particular situation the property market is experiencing. Such head-to-head competition between the public and private sectors can also contribute to keeping prices high; in fact, the more favourable conditions to which government can subject its action (i.e. accelerated approval processes, less stringent application of standards, etc...) can raise the degree of risk faced by private developers, and the higher risk is a pressure factor on prices from the supply side (Hannah et al., 1989, p. 30).

In the next sections, I will more deeply analyse the issue of affordability in Malaysia and indicate alternative paths to be explored.

## **2. A critical approach to housing affordability**

### **2.1 General considerations**

#### **2.1.1 Introduction**

The present section draws heavily on Bertaud (2018, chapter 6) and in general on the work done, together or separately, by Alain Bertaud, Stephen Malpezzi and Stephen Mayo on housing and urban development. Most of the considerations presented below, therefore, can be found laid out more extensively in their scholarly works. Moreover, Bertaud, Malpezzi and Mayo are, together with L.H. Hannah, the authors of a World Bank Report, published in 1989, about the specific situation of the Malaysian property market during the 1980s.

The approach followed here is to place the housing affordability discussion within the framework of a critical analysis that takes into account *both* the demand side *and* the supply side. In fact, some «affordability problems are due to poverty, but in most cases, they are created or exacerbated by human-made constraints on the supply of land and floor space» (Bertaud, 2018, p. 242). From this perspective, it is appropriate to begin by mentioning that, for each household, the current level of affordability is a combination of three elements: floor area, location and price per square meter – or square foot (Bertaud, 2018, p. 242).

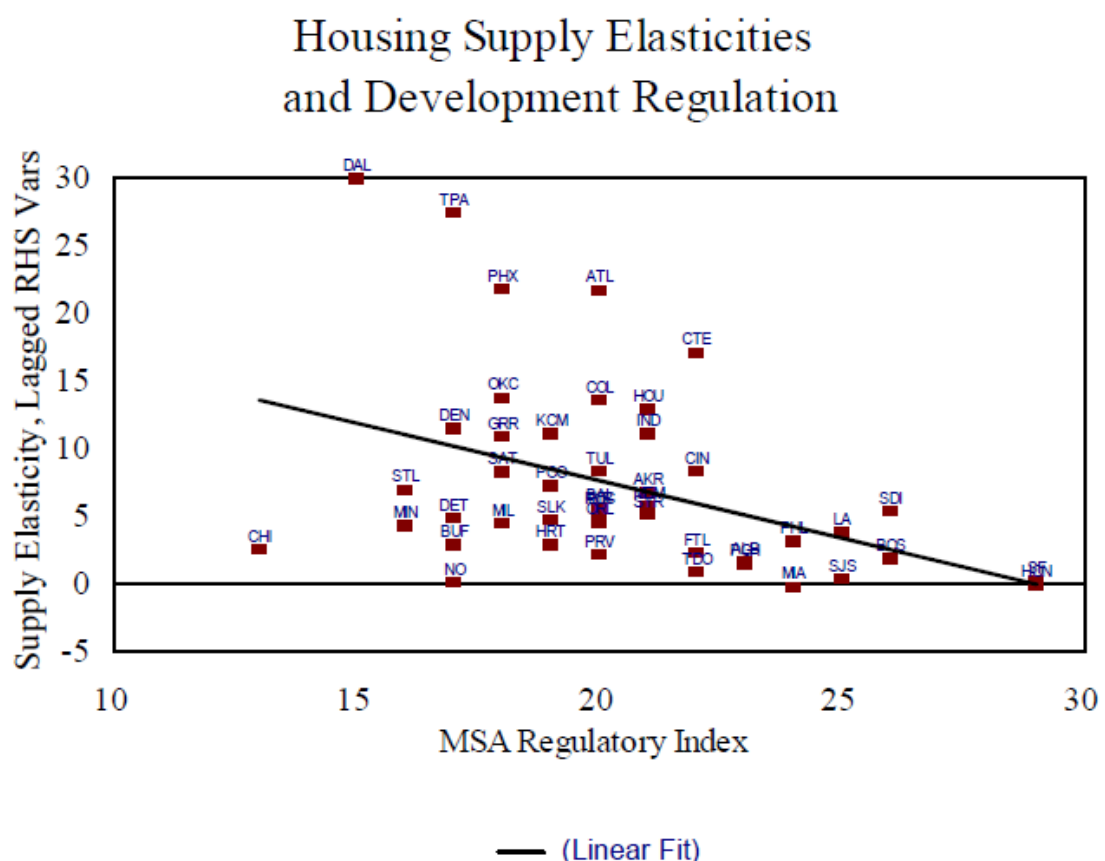
There is more; to say that a certain property is unaffordable to lower-income households is misleading. It would be more appropriate to state that «the minimum lot area allowed by regulations is unaffordable to low-income households within x number of kilometres from the city center», which means that the real issue is not affordability to lower-income groups but «that the quantity of land that is affordable is socially unacceptably small and is unserved by infrastructure, transportation, and social facilities» (Bertaud, 2010, p. 14).

As argued by Bertaud (2010, p. 40), most studies on housing affordability in developing countries merely focus on the price and the composition of new housing, drawing the conclusions that these new units are unaffordable to the poor and the private sector has no interest in entering that market segment, and therefore the government should do something in the form of direct investment or by forcing private developers to intervene with imposed quotas of affordable housing (in this regard the Malaysian case is quite unique; see Rehda, 2018, p. viii). Under the social pressure to do something in order to provide acceptable housing standards at an affordable price for all, government policies make mistakes, starting with often ignoring housing location (Bertaud, 2018, p. 243). By focusing only on income (ignoring floor area and location), government turns people facing issues in getting shelter into a mere statistical group, isolated from the rest of the community, a statistical problem to deal with (Jacobs, 1961, p. 324). Moreover, most government action is based on wrong data, thus drawing wrong conclusions: not only data from the informal sector are disregarded, but it also ignores that the existing stock plays a crucial role in current transactions; there are indeed more transactions in the existing stock rather than in the new supply (Bertaud, 2010, p. 40).

At the same time, «governments often exacerbate the high cost of housing in a city by limiting the supply of housing through regulations and underinvesting in urban expansion».

Green, Malpezzi and Mayo (2005) found, with reference to 45 cities in the United States, an inverse correlation between housing supply elasticity and development regulation (figure 3). Supply elasticity measures how responsive supply is to price movements; in normal conditions, when prices rise, producers respond with an increase in supply. Demand pressure for a product (in our case, 'affordable' houses) tends to increase prices; in the never-ending market process of coordination between supply and demand, developers should respond with an increased quantity of the product in demand: the additional supply plays the role of readjusting price movements downwards. The inverse relationship between development regulation and supply elasticity simply means that an increase in regulation makes it more difficult for the supply to adjust to the demand pressure and this, in turn, keeps prices at high levels: fewer market constraints would facilitate a readjustment of prices toward lower levels.

Figure 3: Housing supply elasticities and development regulation.



Source: Green, Malpezzi and Mayo (2005, p. 19).

Similar considerations can be found in Hannah et al. (1989, pp. iv-vi) with reference to the specific case of Malaysia during the 1980s. From this perspective, Kevin Erdmann (2018, 2019) has shown how housing price inflation during the latest great housing bubble in the us was not only affected by the conditions of the credit market, but also by supply-related issues.

#### 2.1.2 Measuring and facing affordability

When discussing affordability, it is very important to clarify that it is not easy to find a proper measure for it. First of all, it should be said that, when we say that a person cannot afford a

certain good, that person simply does not have a unit of that good (i.e., a car or a computer). However, when talking about housing, saying that housing is unaffordable to households with incomes below  $x$  means that «the trade-offs necessary for these households to rent [or to buy] their current dwelling units are inadequate in terms of rent [or loan] paid as a portion of income, floor area, quality construction, or location» (Bertaud, 2018, p. 245).

This is not the only way in which housing affordability escapes easy categorizations. In fact, scholarly work has revealed that housing is perceived as a necessity more than is commonly understood by policy makers. Policy analysts «who use a single rule of thumb (“households can afford to spend 20 percent of their income on housing”) or who implicitly assume housing is a luxury (“rich households can afford to spend 30 percent of their income but poor households can only afford 10 percent”) are making purely normative statements that are rarely grounded in actual revealed household preferences» (Malpezzi, 2014, p. 4).

The easiest index to measure housing affordability is the price/income ratio (PIR) (Bertaud, 2018, pp. 247-253), which compares the median price of a dwelling with the median household income. While PIR is an index easy to calculate, it does not apply to rent, does not take into account location, and does not really say how much housing can be purchased for the median price. Moreover, a low PIR does not necessarily indicate a good level of welfare; it might be due to economic stress or absence of demand (in turn signalling something wrong about the city or the State under consideration). Therefore, while PIR might be useful for identifying an affordability problem, it is too simple to be the driving force for a policy solution.

As suggested by Bertaud (2018, pp. 261-262), when referring to policies for a specific city, «it is necessary to look at income distributions in which households with median incomes may represent only a very small socioeconomic group. This is particularly true in large cities in developing countries, where incomes are more widely dispersed than in more affluent cities».

Income distribution should be matched with shelter consumption, and one must decide at what point the shelter consumption has fallen below the socially acceptable level (Bertaud, 2018, p. 266). The real question to be posed becomes: how many households live in a shelter below the minimum acceptable home quality? Household income distribution should then be related to housing consumption by income range. A policy focused simply on supplying a certain number of housing units is likely to miss its objectives. In fact, while governments often declare that «the poor housing quality [...] is due to a market failure», it is instead simply due to poverty, as the market tends to provide what people can buy (Bertaud, 2018, p. 271). If government decides to enter the market of housing for low-income households, Bertaud (2018, p. 272) suggested five questions to be asked before implementing any policy.

Figure 4: Five Bertaud's questions.

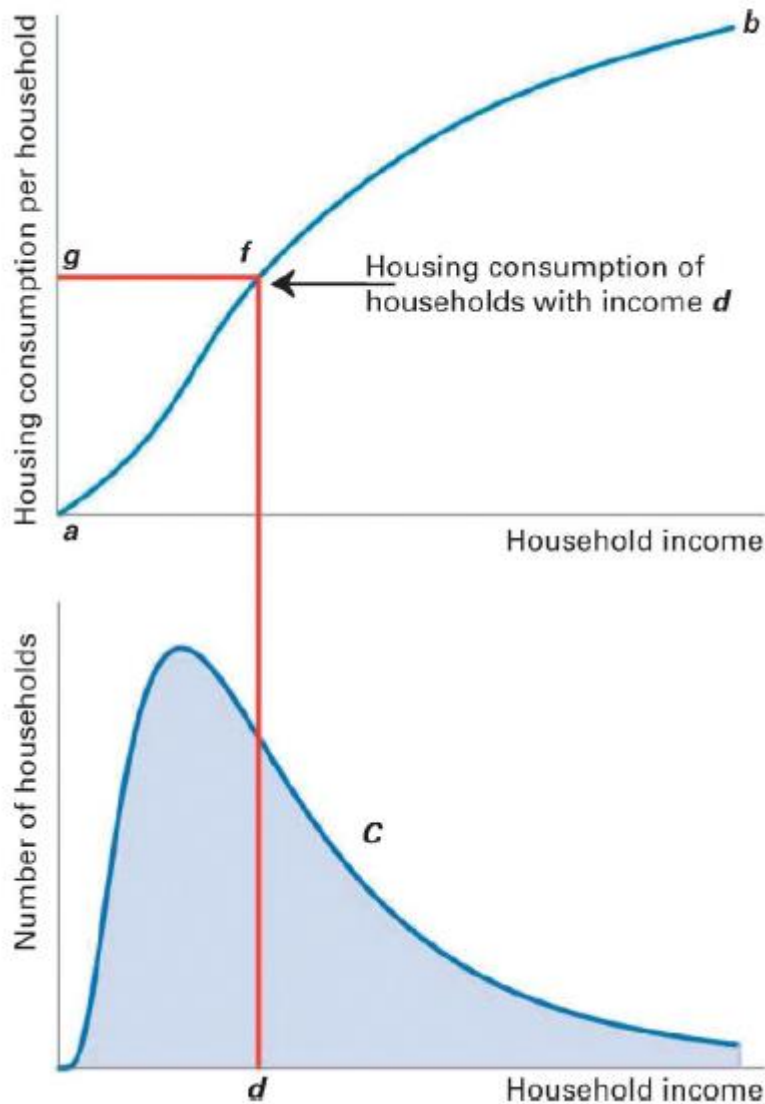
1. How many households should be included? Expressed another way: How far along the income scale should the government become a substitute for the market?
2. What standards should be provided?
3. How many housing units should the government subsidize every year?
4. How many years would be required to provide a subsidized housing unit to all potential beneficiaries?
5. What budget allocation would be required yearly?

Source: Bertaud (2018, p. 272).



A useful tool for such analysis is to link income distribution with housing consumption, as shown in the figure below.

Figure 5: Income and housing consumption – market outcome.



Source: Bertaud (2018, figure 6.12).

The bottom panel shows the relationship between income and number of households (demand side). The top panel shows the relationship between income and consumption (supply side). «The vertical axis displays an index reflecting housing quality that includes floor area but also characteristics like connection to safe water. Alternatively, the housing quality index could be replaced by only one parameter contributing to housing quality, such as floor area per dwelling or water consumption per person.

The curve **ab** in the upper panel shows the variations of housing quality under market conditions in the absence of subsidies. The curve passes through the origin (0, 0), because with zero income the market allows only zero consumption. Usually, as income increases above zero, housing consumption initially increases only very slowly. It then increases faster

when household incomes reach the middle-class level» (Bertaud, 2018, pp. 271-272). To understand the figure: a household with income *d* will consume a quantity of housing *g*.

In a nutshell, each housing policy aims to modify the profile of the housing consumption curve (*ab*), increasing the housing consumption of the lowest income households. One way to achieve this target is to remove supply side constraints (Bertaud, 2018, pp. 273-275), such as administrative duties, minimum floor space requirements, limits on design/technology, etc. While such a measure can produce benefits of different intensity on different income groups, and it may require several years to produce the desired effects, in the long run every household will benefit from it, and it is the option which presents two more strong advantages:

- it is not costly for the government;
- it does not negatively interfere with the market process of preference coordination; rather, it helps supply meet demand more quickly.

The government might instead decide to operate from the demand side by nudging on housing finance; however, only those who qualify for a mortgage can have access to the additional credit. Moreover, if somehow the supply side were restrained by regulatory issues or by land availability, the ultimate outcome would only be to increase prices rather than housing consumption (Bertaud, 2018, p. 277). Among the supply side constraints, minimum requirements such as dwelling size should be mentioned; their main result is to increase the size of the informal sector.

Another type of support from the demand side, for the rental market, is constituted by rental vouchers: subsidies covering the amount of money necessary to low-income households for fully paying their rents. The implementation time plays a crucial role for this subsidy to work; the presence of bottlenecks from the supply side might result in increasing prices, as in the case of Malaysia during the 1980s (Bertaud, 2018, p. 285).

Since the issue of affordability is so complex, and different potential policies imply several undesired unintended consequences, it is necessary, before deciding whatever policy to adopt, to first find the cause of high housing costs; second, the quantity of households affected by the problem needs to be identified. Only after these two issues are clearly settled can a housing policy be implemented; moreover, it needs to be constantly monitored in its intended *and* unintended outcomes (Bertaud, 2018, p. 324). The first two steps are often ignored because governments assume that poor housing conditions for the lower-income households are necessarily due to market failures and that the real estate industry will never supply the so-called affordable units; it is enough to mention the several cases when, due to regulation constraints on the provision of affordable housing, the informal sector takes over.

While the course of action is not easy to identify, it should be noted that temporary mismatches between supply and demand are at least partially unavoidable, as the housing market is characterized by cyclical fluctuations, and the housing industry is an industry requiring long-term investment projects in order to see the fruits of those investments. This means that the coordination process between supply and demand is necessarily time-consuming and, even in the absence of disturbances from the demand or supply side, a certain cyclical dynamic will be observed. Such observation is consistent with the model of the *natural cycle* developed in Ferlito (2014; 2016 chapter 3), applied to the Malaysian property market in Ferlito (2018a, 2018b).

The most fruitful policy is the one that places supply side reforms before demand stimulus, in order to support improvement of a market in which supply can more easily adjust to the signals coming from the demand side, in a process that will always unfold in time.

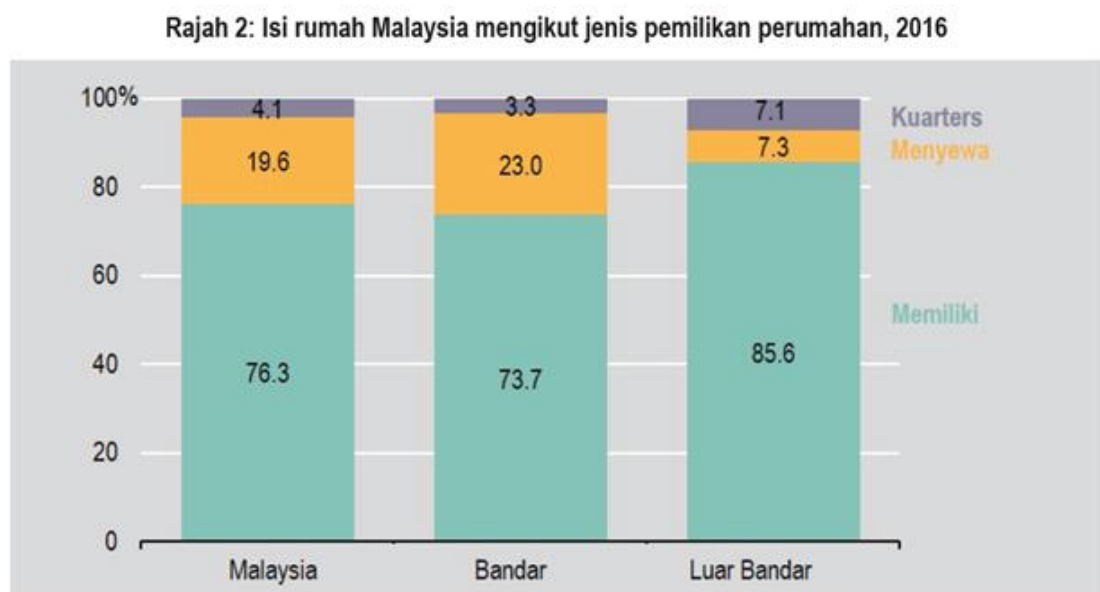
«I have often compared very restrictive urban regulations to hard drugs and cities that practice them to drug addicts. Trying to suddenly remove their drug fix creates severe side effects, because their organism is used to the drug and needs it, even as they are being destroyed by it. My guess is that any serious reformer should approach urban regulatory reform in the same way as a doctor develops a treatment for a drug addict: a progressive withdrawal planned over the long term» (Bertaud, 2018, p. 329).

## 2.2 The Malaysian case and the National Housing Policy 2018-2025

In the present section I will discuss *if* there is an affordability issue in Malaysia and eventually to what extent. After such analysis, I will critically focus on the policies that are implemented or proposed by the government in order to tackle the issue.

As mentioned above, the PIR is an indicator with limited explanatory power, and therefore it should not be taken here as the measurement for the affordability issue<sup>2</sup>. In fact, the topic is much more complex and needs to be faced in light of such complexity. The first point I wish to stress is the home-ownership rate. In Malaysia it is still at 76.3 per cent (figure 6); even if, as with all average values, the figure suffers from many limitations, looking at it in comparison with other countries will help us understand how the indicator is not pointing toward a dramatic situation.

Figure 6: Homeownership in Malaysia – 2016.



Sumber: DOS (2017c)

Source: DOS.

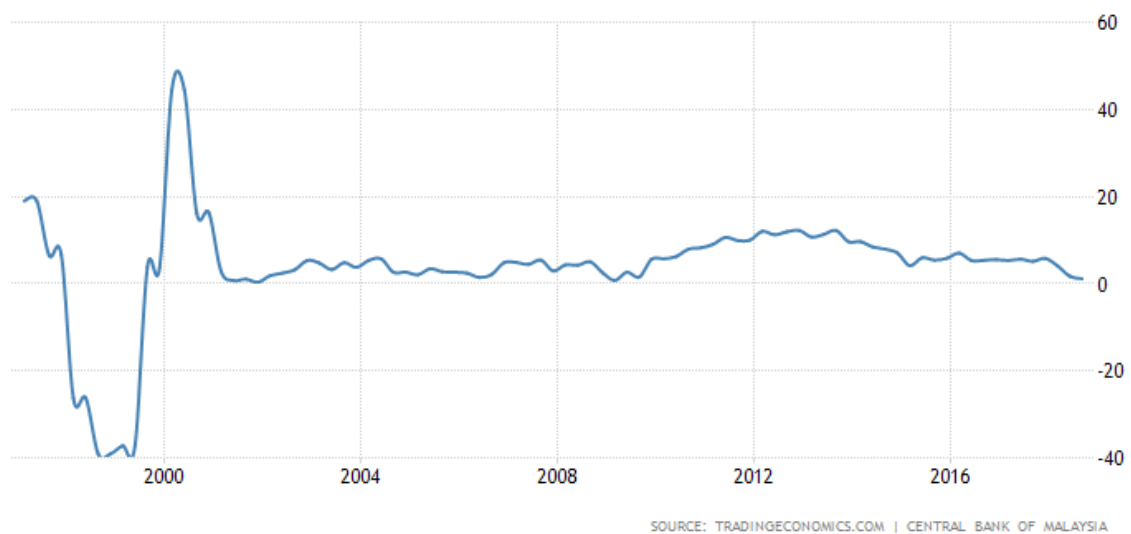
While Singapore scores among the top countries in the world for home-ownership (90.3 per cent), available regional data report South Korea with 56.8 per cent, Japan with 61.6 per cent, Hong Kong with 49.2 per cent and urban Indonesia with 67 per cent. The ratio is 65.5 per cent in Australia, 64.5 per cent in the United States, 63.5 per cent in the United States,

<sup>2</sup> For a comprehensive analysis of the Malaysian case using PIR as the main parameter, see Rehda (2018) and Ismail (2019).

while 69.3 per cent is the average value in the European Union. Looking at Malaysia from a relative perspective, thus, we cannot say that the country is suffering from an ownership issue.

If home-ownership is not an issue in itself, what is instead concerning people seems to be the dynamics of housing prices in comparison with wages, which are perceived as stagnant. We will soon see if such a perception is correct or not, but, even if it is not, perception is important in itself; in fact, what is guiding people's choices, which are also consumption choices, is the perception and the interpretation of facts, rather than the facts themselves (see Ferlito, 2018c, 2019).

Figure 7: Malaysian Housing Price Index – 1997-2019.

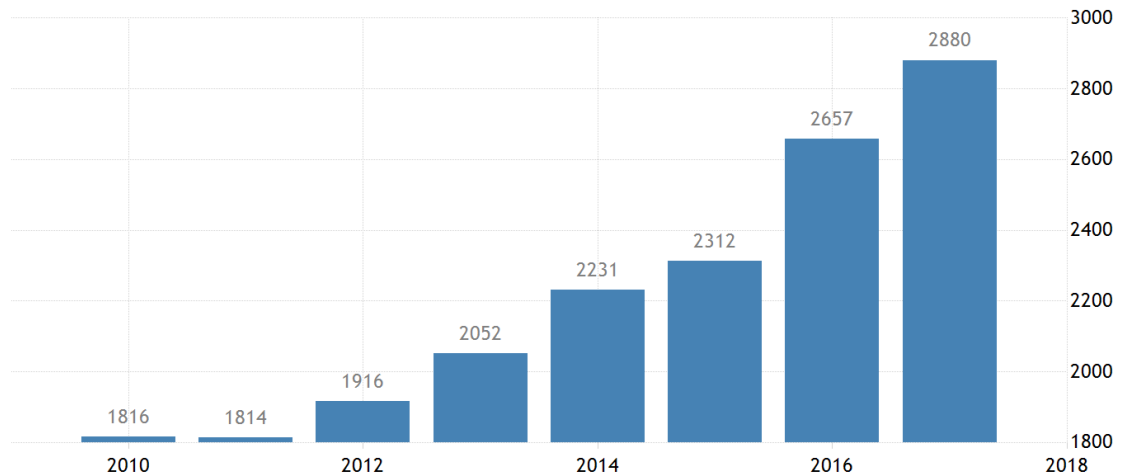


Source: Tradingeconomics.com.

Housing prices dynamics over the past decade are consistent with the cyclical dynamic discussed in Ferlito (2018a, 2018b): while prices rose at a higher pace during the peak of the boom (2008-2012), their dynamics started to cool down afterward and the latest increase was close to only 1 per cent. While in the past twenty years housing prices averaged a growth of 4.07 per cent per year, the pace was stronger in the last ten years (+6.5 per cent average annual growth); however, it is slowing down, and in the past three years the average annual growth was 4.8 per cent. As of 30 September 2018, the Malaysian median housing price was RM 293,000, while the average house price was RM 383,648 (EdgeProp.my, 2018).

What about wage dynamics?

Figure 8: Malaysian Average Wage – 2010-2017.

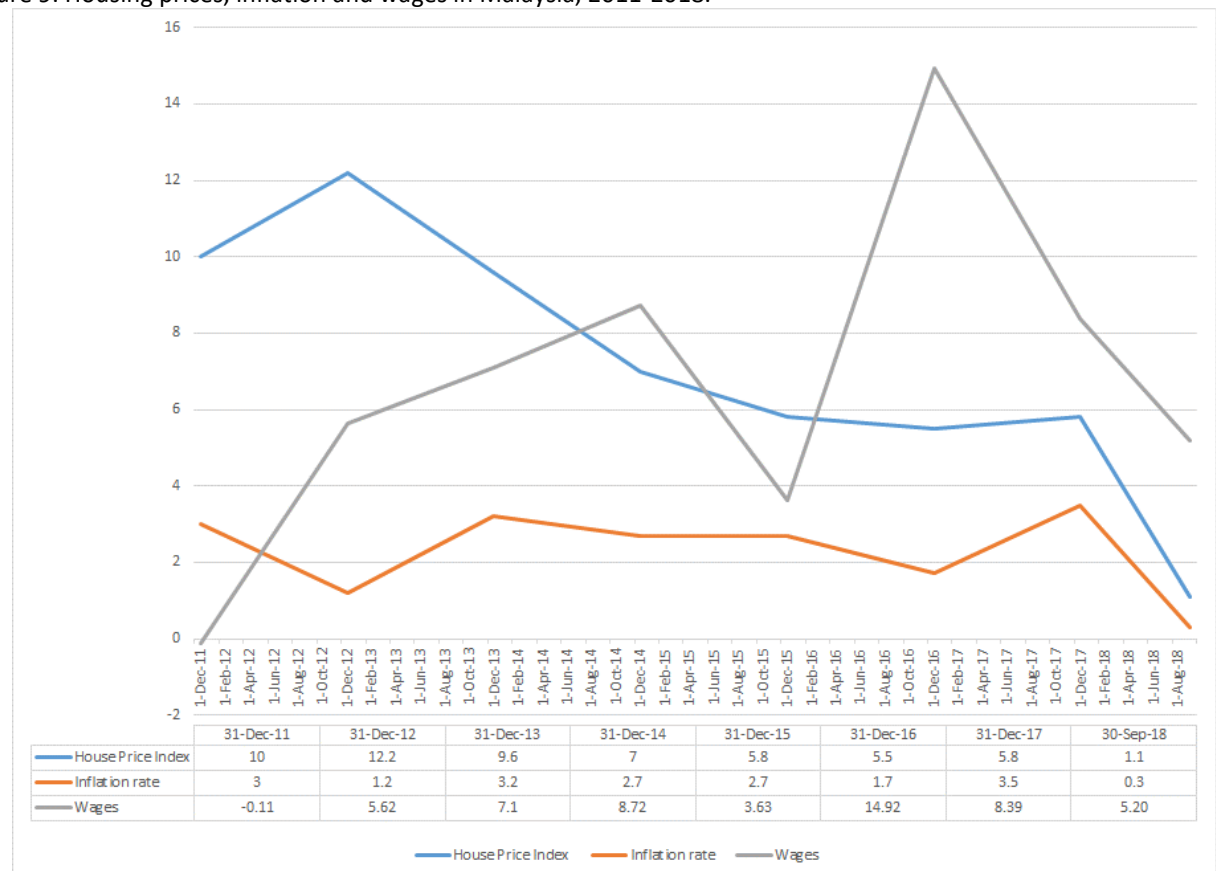


SOURCE: TRADINGECONOMICS.COM | DEPARTMENT OF STATISTICS, MALAYSIA

Source: Tradingeconomics.com.

Even if during the initial phase of the property boom wages grew slower than housing prices, they are now gaining pace and the average yearly growth since 2010 has been 5.8 per cent. Figure 9 compares housing price dynamics, inflation and wage increases in Malaysia between 2011 and 2018.

Figure 9: Housing prices, inflation and wages in Malaysia, 2011-2018.



Source: Our re-elaboration on Tradingeconomics.com data (2018 salary data are an estimation from Mercer; see Chin, 2018).

Figure 9 shows how housing prices rose faster than inflation over the past eight years, but since mid-2017 they are converging and most probably consistently contributing to the Malaysian price decline. At the same time, wages are accelerating more than proportionally and it is reasonable to assume that, with the overall downturn experienced by the property market, the divergence between them and housing prices will be further reduced. If we look at Malaysia's general deflationary process and at wage dynamics, we can be confident that, at least in the short run, housing will be less unaffordable than it used to be.

It is in light of the scenario described above that the new National Housing Policy needs to be contextualized and judged. The five focuses highlighted in the NHP 2018-2025 are:

1. ensuring quality standards in the provision of housing for everyone;
2. improving accessibility to the market and the ability to own a home;
3. ensuring a quality and cohesive neighbourhood;
4. improving coordination between development and transportation systems for a better quality of life;
5. strengthening the institutional capacity to implement the NHP.

Focus 1 is quite critical and, while appearing to be oriented toward meeting the needs of the poor, the way it will be implemented may generate distortive and even regressive effects. As mentioned by the NHP, quality housing refers to the provision of housing that meets minimum standards and is well maintained and equipped with facilities and aspects of comfortable ventilation; the government intends to develop objective measurements for housing quality. It is not yet clear which criteria will be used in defining such parameters, but it is important to stress how a too-restrictive approach may lead in the opposite of the desired direction. Ikeda and Washington (2015) provided theoretical evidence and empirical support for the belief that minimum size requirements, parking requirements and even the more recent smart growth regulations have the effect of increasing the cost of housing: this «effect makes everyone in cities with high housing costs poorer by reducing the income that they have available to spend on other goods» (Ikeda and Washington, 2015, p. 19). We stressed above how the issue of affordability should be treated by considering the trade-off between three elements: price, floor area and location; imposing, for example, minimum size requirements for the development of affordable housing can increase the price factor (by raising construction costs) and force people to compromise in favour of a location far away from their workplace. Instead, a market approach, leaving supply to meet the actual demand requirements, may lead, *ceteris paribus*, to the creation of smaller units but closer to the economic heart of cities and thus to job opportunities. How to choose when faced with the trade-off between location, price and floor space should be left to individual choice, which avoids preventing opportunities because of too-strict regulations. The (unintended) consequences on the general economic environment should not be disregarded: «these rules are most binding in cities that are centers of innovation and job growth, thereby limiting opportunities for people to move to those areas in pursuit of economic opportunity. Restricting access directly hurts individuals who would like to move to a specific city in pursuit of economic opportunity if the housing supply were not a barrier. However, in the long run restricting access to urban centers of job growth and innovation is also detrimental to national economic growth and income mobility as people are barred from living where they could be most productive» (Ikeda and Washington, 2015, p. 25). It should be noted that recently the mayor of Kuala Lumpur supported the creation of micro-houses (Soo, 2019), thereby moving against the government idea of providing houses with minimum size requirements; this is an example of how the lack of coordination between policy makers might lead to even higher

regulation costs. But this is not the whole point: neither the government nor the mayor are right in themselves; as argued by Ikeda (2004, p. 261), the issue «is not “planning versus no planning,” but rather “who should do the planning” [...] local knowledge that is relevant to the success of a community is contextual, at least partly inarticulable, and thus difficult if not impossible to transmit effectively to central authorities. [...] whether society makes the best use of that knowledge will depend on the extent to which public choosers are willing to rely on nongovernmental mediating organizations and emergent social institutions». Therefore, while issuing certain minimum safety standards, as much as possible other standards should be left free to be discovered by the interaction between supply and demand – which is a process of dynamic discovery that happens over time and thus not possible to plan in advance – in order to make the choice among the three elements of the affordability trade-off as consistent as possible with people’s expectations and prevent the emergence of barriers to general economic growth.

Focus 2 is mainly devoted to the promotion of new technologies in the development of affordable housing orders and to new financial solutions. These are two important points. First of all, a well-developed financial system can indeed create better support for new buyers entering the game. Secondly, new technologies are key to enhancing competition and bringing prices down. Regarding the financial perspective, my advice is not to implement artificial credit situations in which the financial system is creating, rather than supporting, demand for new houses. As explained in Ferlito (2018a, 2018b), such a scenario would be harmful in several ways: creating financial instability for people (in a country with a high household debt), creating discoordination between consumption and investment decisions, and keeping house prices high. On the issue of technological development, instead, while it is clear that it is key for new affordable housing solutions, it opens the question on how disruptive entrepreneurship is actually generated and whether technological development can be a result of central planning; this issue will be touched on in the next section on policy suggestions.

While I agree with the general purpose of Focus 5, as each policy should be monitored after it is implemented, focus 3 seems to be concerned with the creation of good neighbourhood spirit; it is not clear how it will be implemented, but I am quite sceptical of the fact that such a spirit can indeed be created by a central planner. In this respect, where government should focus is in keeping the community safe in order to promote the level of mutual trust, as it is such mutual trust that guarantees, in a densely populated settlement such as a city that is characterized by a high degree of diversity among its members, the emergence of entrepreneurship and therefore of economic development (Ikeda, 2004, p. 250).

Focus 4 is very important when it stresses the importance of developing infrastructure; it encounters the fact that location is an important element in judging affordability. In this respect, complexity should be taken into account. No solution is preferable *ex-ante*; a serious study should be conducted on the different costs and benefits provided by different transport solutions, with reference to specific areas, not focusing simply on public transportations *stricto sensu*, but also on the possibility of implementing the road system.

Few words need to be spent on the government plan of building one million affordable housing units in the next ten years, with an average of 100,000 units per year. Actually, the plan is not explicitly mentioned in the new housing policy; however, the point is among the promises in the Pakatan Harapan Manifesto (Pakatan Harapan, 2018, p. 22) and is widely discussed in the policy debate (see, among others, Perimbanayagam, 2019). The debate is

about the actual possibility for the government to deliver such a high number of homes when the previous ruling class failed at it; additional arguments are brought about the eventual cost to be paid for such an ambitious project. These issues are relevant but misleading; in fact, the real question to be asked is not whether the government can fulfil the promise, but rather, does the market need those houses, with certain features, at a certain price, within certain locations? That is not possible to answer in advance. By nature, government is operating outside the market and therefore will never be able to acquire the knowledge necessary to implement a sound entrepreneurial plan, based on actual market needs (knowledge problem: Hayek, 1937, 1945), and will never be able to judge whether its plans were profitable, as the prices linked with government housing projects are not coming from the market but arbitrary political figures (calculation problem: Mises, 1920). Following Hayek, in fact, we must distinguish two types of knowledge, which I call technical knowledge and entrepreneurial knowledge; the first type is the knowledge about *how to do things*, while the second type regards *when and where to do what*. While a central planner (whether the government, an agency or a team of experts does not make any difference) can eventually possess the technical knowledge, it can never acquire the second type of knowledge. It is therefore easy to understand how the problem does not consist in the government being able to build one million housing units, which is merely a technical issue that is possible to overcome with technical development; the real issue is the possibility for the government to be able to deliver something that can actually be absorbed by the demand, whose features are going to change dynamically over time. The information relevant for entrepreneurial decisions is, by nature, dispersed in individual minds, unarticulated, tacit, ever-changing and often non-directly transmissible; it arises through inter-individual interaction in the market dynamically and over time; a central planner would never be able to possess it and, even if the planner were able to capture it for an instant, it would already have evolved with the genuine novelty created by the mere passage of time. Entrepreneurs too cannot have perfect access to such information, but, playing within the market, they are better exposed to the transmission mechanism which involves that information. Such a mechanism happens with the mediation of prices, which are indeed the objective synthesis of billions of dispersed subjective evaluations; without the dynamic market process, prices could not emerge and could not exercise their function of transmitting the relevant entrepreneurial information. Again, government action, happening outside the market, would also not have access to real prices, and therefore would lack the necessary instruments to evaluate the economic sustainability of its plans (see Ikeda, 2004).

### **3. Policy proposals**

#### **3.1 Proposals for the crisis**

As mentioned above, I believe that the main concern for the next policy discussions and actions should be the downturn of the property market and its potential consequences for the Malaysian economy. Here I am going to recap the main points suggested in Ferlito (2018a, pp. 24-25).

Over the past decades, the outbreak of an economic crisis was always faced with a mix of monetary and fiscal policies, focused on monetary easing and fiscal stimuli. However, as experience in the USA demonstrated with particular reference to the Great Recession



(Gjerstad and Smith, 2014, p. 279), traditional policies failed to properly address the problems faced after the housing bubble. First of all, in fact, monetary easing should be recognized as one of the items that fuelled the bubble and therefore cannot be used as a potential remedy. This was true for the American case, characterized by the development of special financial instruments which increased household risk, but it is also true for the Malaysian situation. Moreover, the high level of Malaysian household debt (83.8% of GDP) suggests a balance sheet crisis situation, similar to the one analysed by Gjerstad and Smith (2014), where we find «large inventories of homes on the market and the central bank might lose control over housing and mortgage markets having therefore limited ability to stimulate a recovery. Government deficit spending might be ineffective for the same reason: Too many households [...] are mired in negative equity, and the financial system stalls in the slow process of diverting income into debt reduction» (p. 279).

While it will be difficult to manage the outbreak of the crisis, it will be important to prepare the institutional ground in order to reduce the consequences from future boom and bust cycles and to manage the period that separates the housing market from the bust. Gjerstad and Smith (2014, pp. 281-282) suggested first a restructuring of property rights to limit the consequences of financial imbalances between borrowers and lenders; one measure is to introduce stricter down-payment rules. The authors remind us of the tradition, backed by experience, according to which mortgage, property insurance, and property taxes should not exceed 30 percent of income. Moreover, whereas the loan originator compensation fee should be determined by the market, «its time distribution must be geared to the time profile of borrower payments so that an originator cannot off-load the risk to a third-party lender; loan default must have consequences for the originator of the loan and induce due diligence in the originator's own self-interest» (p. 231).

Moreover, although I am not keen in suggesting a higher level of government intervention when taking into account exceptional situations, like a deep crisis, I agree with Gjerstad and Smith (2014, p. 283) when they suggest that in such cases public policy should target homeowners' negative equity. Gjerstad and Smith (2014, pp. 236-237) suggested to do «for households what the Fed sought for the banks [...], seeking to reboot homeowners' damaged balance sheets in an effort to arrest a prolonged deleveraging process and more quickly restore household demand to levels no longer dominated by negative home equity». Among bad options, this might be the one with the least damaging consequences.

From a fiscal perspective, it might be useful to follow what Irving and Herbert Fisher proposed regarding a shift from an income to a consumption tax (Gjerstad and Smith 2014, pp. 284-285). Applying this argument to the Malaysian case, tax reform shifting from an income tax toward a consumption tax might bring out positive effects. A consumption tax, which tends to shift consumer orientation to the future and favours saving, could be the best remedy for more sustainable long-term investments. This could further enrich Malaysia's economic system. A consumption tax should replace, or partially replace, the present income tax – not simply add to it. Simply adding new taxes could dramatically frustrate economic activity. A shift of the fiscal burden from income to consumption, instead, could drive better quality growth. Following Fisher and Fisher's logic, business income would be taxed only once at the individual-household level and only insofar as it is consumed. Hence, all business taxes would be abolished (Gjerstad and Smith 2014, p. 285). This is not the direction taken by the new Malaysian government. A mix of GST<sup>3</sup> and reduced income taxes can be studied in order

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<sup>3</sup> Good and service tax.

to ensure a source of income for the government from one side and to orient consumer attitudes toward saving, and so support re-building the monetary funds available for investment projects. Such a measure, moreover, would help to move the household debt outside the red zone in which it is presently located.

The suggestion to remove tax- and transactions-cost barriers to the formation of new businesses moves in the same direction (Gjerstad and Smith 2014, p. 245). This would help the economic system seek a path toward a capital reorganization consistent with the new economic scenario, avoiding blocking resources in industries which do not offer profit opportunities.

From the government's perspective, it would be important to work more on the importance of fiscal discipline. Uncertainty over how deficits will be financed creates regime uncertainty (Koppl 2014, p. 133). Fiscal discipline moves together with a path toward monetary stability and confidence that such stability will not suddenly evaporate (Koppl 2014, p. 135).

### **3.2 Proposals for affordable housing**

#### **3.2.1 Remove distortions from the supply side.**

As mentioned above, I believe that the most fruitful effort would be to focus on the removal of supply-side bottlenecks, in order to allow the supply to more easily adjust to the signals coming from the demand. As demonstrated by Hannah et al. (1989) with reference to the Malaysian case in the 1980s, the set of regulations involving the local property market is impeding the private sector from acting effectively in support of demand; this lack of action from the supply side is not only failing to provide shelter for low-income people, but also keeping the prices on the high side because of demand pressure. Revision of the institutional framework «designed to increase the supply of low-cost units» should be designed in such a way as to increase the possibility for the supply to meet market preferences «by removing the cost distortions created by some of the legal minimum standards. The removal of those distortions stimulates developers to produce more low-income plots where the demand is the greatest and not necessarily where land is the cheapest» (Bertaud and Malpezzi, 2001, p. 410). The last sentence again emphasizes the fact that affordability is not only a matter of price but also of location and size.

The issue of making the supply curve less inelastic is more crucial than what is commonly understood. As argued by Malpezzi and Wachter (2005), «inelastic supply curves can give rise to “boom and bust” markets, and are the real cause of market instability, rather than “speculators”» (Malpezzi, 2014, p. 5). Malpezzi (2014, p. 5) also argues that such cycles are exacerbated «by badly designed government responses to rising housing prices by one-time programs to get the market moving, as in a “Million Houses Program;” [...] The analysis suggests it would be more effective to tackle rising prices by improving the efficiency of the supply of developable land, and real estate generally, including the development of an appropriate regulatory framework for real estate. Reform measures that tackle the root causes of inelastic supply have the effect of flattening the supply curve and moderating the boom and bust cycle, reducing risk for investors».

What are the factors that are presently contributing in Malaysia to the inelasticity of the supply curve for affordable housing? First of all, the government agencies involved in the

provision of affordable housing<sup>4</sup> (see Ferlito 2018a, pp. 26-27): here the problem is not to reduce them from twenty to six, as proposed by the government, as the knowledge and calculation problems explained above will apply in any case. The point is that direct government action in the field will necessarily create obstacles to private attempts to enter that market segment. Moreover, as previously discussed, such direct intervention usually does not take into account the affordability trade-off of the three basic elements (price, size, location). In a less evident but equally distortionary way, other regulations are impeding the mode and speed of an adequate private supply of affordable housing by private developers; I should mention here the bumiputra quotas in low-cost housing projects and the compulsory affordable housing quotas for private developers. Both these measures impede the supply moving in the direction signalled, via the price mechanism, by the demand. Similarly, and as previously discussed, all the too-strict requirements that surround the building of affordable homes, such as minimum size, impede a sound coordination between supply and demand and, as argued above, have regressive effects and in the medium run can limit general economic growth. The same considerations apply to the extra regulatory costs created by different forms of subsidies (Hannah et al., 1989, pp. 59-60). My suggestion here is that government agencies involved in the provision of homes should be frozen in their power to act. Similarly, all the other elements limiting the elasticity of housing supply and the involvement of private developers in the low-end segment, such as the bumiputra quotas and time-consuming and contradictory regulations or minimum size requirements, should be quickly removed to allow supply and demand to react faster to mutual signals coming from the price system and to allow a better and free choice when facing the trade-off between price, floor area and location.

The point to be made clear is that the low-end market segment is not disregarded by private developers because it is *naturally* unprofitable, but because it is *artificially* made unprofitable by the regulatory obstacles mentioned above.

### 3.2.2 The importance of creative destruction

The current national housing policy suggests that the government is aware of the positive effect that technological development can exercise on prices, bringing them down. However, the process of technological development, which, following Schumpeter (2011), becomes innovation when applied to the production process, is not something that can be developed *ex-cathedra* via central planning (as Schumpeter, 1942, seems to suggest), for the same reasons described above when analysing the knowledge and calculation problems.

The phenomenon of creative destruction, the competition between the emergence of something new in the economic system and the struggle for survival played by what is old, is, as suggested by Schumpeter, the essential fact of capitalist development. The battle for new elements (new products, new markets, new methods of productions, etc.) to emerge is happening in the market and, in the market, it brings along a downward movement of prices. In order to be carried out, innovations need special types of people – entrepreneurs – that are, first and foremost, alert to unexploited profit opportunities (Kirzner, 1973). When their alertness generates economic ventures able to play a disruptive role in the market process,

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<sup>4</sup> Government is considering to shut down one of these agencies, PR1MA (Aziz, 2019), because of its poor economic performances. It is a good start, but the motivations behind the move are the proof that the government did not realize that such outcome was and is unavoidable because of the knowledge and calculation problems described above.

they are creative entrepreneurial actors in the Schumpeterian sense – a situation that can be judged only ex post (Ferlito, 2015 and 2018d).

However, such alertness can be exercised only in the market and thanks to the signalling role played by the price mechanism; for this very reason, entrepreneurship, being the response to stimuli arising in the market, cannot be planned by any single player outside it.

If technological development applied to affordable housing is therefore welcomed, in order to emerge it requires a high degree of entrepreneurial freedom to maneuver so that market signals can be captured by alert entrepreneurs. From a policy perspective, thus, the role of government should not be that of an entrepreneur – this would be ontologically impossible – but to remove obstacles, such as transaction-cost barriers and direct business involvement, which might disincentivize the formation of new businesses (Gjerstad and Smith 2014, p. 245). This would help the economic system seek its path toward a capital reorganization consistent with such new possibilities, avoiding blocking resources in industries which do not offer profit opportunities.

### 3.2.3 The rental market, with a modest proposal

I believe that the rental market will play a growing role in the Malaysian market in the future. I see this not only because of merely economic considerations; I also base my analysis on cultural factors that are often disregarded in policy discussions, but that can be decisive in understanding the complexity under examination<sup>5</sup>. From a purely economic perspective, it is easy to understand that, since Malaysia is on a fast track to become a developed country, it is not realistic to expect that housing prices will be where they were before the development process. Do not forget that between 1976 and 1982 housing prices rose by an average of 18.6 percent per annum, and in the same period household income rose by only 10.8 per cent per annum (Hannah et al., 1989, p. 6); the current dynamics, described above, seem less discouraging. In the present evolutionary scenario, the housing market should be analysed considering it as a whole, including an increasing role for the rental market.

As previously mentioned, I believe that such a trend will not be driven simply by economic factors, but also by cultural elements. As demonstrated by preliminary studies on the evolution of spending habits, the generations currently entering the housing market from the demand side are living between the cultural pressure from previous generations about the importance of saving for and buying a property as soon as possible and the new, more present-oriented and dynamically evolving mentality, which emphasizes the role of entertainment expenditures, such as those devoted to traveling or new communication devices. According to the Department of Statistics, on average in 2016 Malaysians spent 13.4 per cent of their income on restaurants and hotels. It is quite striking that only 1.9 per cent of the expenditures was devoted to health, while 5 per cent was spent in communication and 5 per cent in recreation services.

In such an evolutionary scenario, and considering what has been said in the previous sections, while rent-to-own schemes are welcome and deserve to be incentivized, a different role might be conceived for the government in facing the shelter issue. A solution that overcomes the problems created by subsidies, vouchers and direct government housing investments is the so-called guaranteed-rent method, suggested by Jacobs (1961, pp. 326-

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<sup>5</sup> In contemporary economics Don Lavoie has probably been the strongest advocate of the importance of cultural studies for economic analysis, followed by Emily Chamlee-Wright and Virgil Storr. See, in particular, Lavoie and Chamlee-Write (2000), Storr (2013), Storr and Grube (2015).

331). This is a way to introduce «new construction gradually instead of cataclysmically, of introducing new construction as an ingredient of neighborhood diversity instead of as a form of standardization, of getting new private construction into blacklisted districts and of helping to unslum slums more rapidly» (Jacobs, 1961, p. 326). With the implementation of this method, the «physical units involved would be buildings, not projects – buildings to go among other buildings, old and new, on city streets. These guaranteed-rent buildings would be of different kinds and sizes, depending on their kind of neighborhood, the size of the plot, and all such considerations as normally influence the size and type of more or less average dwellings» (Jacobs, 1961, p. 326).

The system of guarantees suggested by Jane Jacobs would move in two directions. In case the developer is able to get a loan through the traditional financial market, the government (or one of its agencies) would guarantee the mortgage; in case the developer fails to do so, the public authority would become the money lender. The second action from the government side is to «guarantee to these builders (or to the owners to whom the buildings might subsequently be sold) a rent for the dwellings in the building sufficient to carry them economically» (Jacobs, 1961, pp. 326-327). In exchange, the builder would be required to select tenants from the group of people designated by the government agency in charge. By examining the applicant's income, the agency would decide how much of the economic rent could actually be paid and make up the difference; if «a household's income improved, its proportion of the rent would go up, and the proportion provided by the subsidy would go down. It and when a household reached the point of paying a full economic rent, it would thereafter – for as long as this was true be» no concern for the public authority (Jacobs, 1961, pp. 327-328).

The most important difference with a traditional program of public housing is that with the guaranteed-rent method the capital costs are not directly borne by government; with this system, they would be kept in the rent equation, when defining the total economic rent to be received by the builder. Real estate taxes could also be incorporated in the rent determination (Jacobs, 1916, p. 329). Moreover, the agency in charge should not be involved in the details regarding construction standards; such a choice would be left to developers and determined by market conditions.

Such a solution implies a lower financial burden for the government, a burden that would decrease if the households renting these units improve their economic conditions. This would be all the more true and likely to happen if no restrictive barriers were imposed on location. This would create the possibility for the poor to choose dwellings closer to the economic heartbeat of a city, increasing their chances for social mobility. At the same time, the risk of the emergence of slums, devoted to poor people, in locations that would ultimately keep them poor, would be avoided, or at least drastically diminished.

#### **4. Conclusions**

Starting with summarizing the major findings presented in Ferlito (2018a), the present work highlights how the housing affordability issue in Malaysia needs to be addressed in light of the general dynamics of the property market. While the current political debate is mainly focused on home ownership, the industry is suffering a downturn that might lead to a wider economic crisis. Failing to recognize this fact would lead to the risk of being unprepared for an economic downturn.

In order to face a downturn in the property market, this paper suggests primarily acting to address home-owners' negative equities. Furthermore, fiscal discipline and strict down-payment rules are recommended, together with a redesign of the fiscal system in favour of consumption taxes rather than income taxes.

With regard to the affordability issue, the present study affirms that home ownership is less of a problem than what the political debate would tend to suggest: with 76.3 per cent of home ownership, Malaysia is performing better than neighbouring countries. The affordability issue is a complex one, and looking at it simply by looking at the ratio between median house price and median income is simplistic and misleading; in order to decide what is affordable is a choice involving a trade-off between three elements: price, floor area and location. The point raised here is that the low-end market segment is not disregarded by the private developers because it is *naturally* unprofitable, but because it is *artificially* made unprofitable by a series of regulatory obstacles that become supply-side bottlenecks. The better way to generate affordable projects would be to remove those obstacles, starting with the agencies directly involved in building low-cost homes. Similarly, in contrast with what is suggested by the NHP, too-strict requirements for such developments should be avoided in order to facilitate the interaction between supply and demand, taking into account the location and size factors, and therefore allowing lower income people to move toward the economic heart of the country, supporting thus not only their housing issues but also promoting their possibilities for a higher degree of social mobility.

Disruptive entrepreneurship will play a key role in developing new technologies for making housing developments cheaper from the cost side. However, in order to emerge such kind of entrepreneurship requires freedom to react to market signals and cannot be centrally designed, because of the specific nature of entrepreneurial discovery processes.

A higher role for the rental market is expected to emerge in the future. Under this perspective, the government might consider Jacob's proposal of guaranteed-rent homes, where the central authority guarantees the loan for those developers investing in affordable projects, and partially covers the rent disbursement, in order to make the projects both affordable and economically viable. This method would have the advantage of avoiding capital expenditure from the government side, and moreover of decreasing current expenditures whenever the subsidised tenants improve their economic conditions.

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