Forced errors

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WHEN Tata Motors wanted to build a factory for the Nano, a cheap "people's car", the Indian state of West Bengal seized 1,000 acres (400 hectares) of farmland on its behalf at Singur, just up the motorway from Kolkata. The state government invoked a colonial-era law to forcibly acquire the plot in 2006 from 13,000 landholders, many of them unwilling sellers. Protests against the purchase continued even as the factory was being built. Tata eventually fled. Narendra Modi, then the chief minister of Gujarat, offered it a way out by providing it a factory-ready plot there.

The Singur protests have come back to haunt Mr Modi, who is now India's prime minister. They led to a new law in 2013 which set arduous terms for coercive land purchases. Mr Modi is trying to relax these rules for certain categories of project, such as rural infrastructure, industrial parks and low-cost housing. It is now his government that faces protests from farmers. Yet if India is to become richer, it needs to be able to build roads and factories.

The economic case for allowing the state to acquire property by coercion starts with the Coase theorem, named for Ronald Coase, a Nobel prize-winning economist, which says that private bargaining should produce ideal results for society if property rights are well defined.* Yet the costs of such bargaining—verifying the quality of the asset, say, or legal fees to make the transaction official—are rarely low enough to allow for an efficient outcome, as Coase himself emphasised. This is all the more so where property is fragmented, as it was at Singur.

The problem is not restricted to land or other physical goods. New medicines and electronic gadgets can also be delayed or never made because of "patent thickets", a term coined in the 1970s to denote clusters of intellectual-property rights. Such logjams long predate the electronic age. In the early years of aviation it was nearly impossible to build an aeroplane in America because of the number of different patent-holders involved, writes Michael Heller in his book, "The Gridlock Economy".

Economists and legal scholars have justified forced purchases when the transaction costs of stitching together many small properties are too high for a deal to be reached by consensus. More precisely, it can be used to overcome the power of so-called holdouts. A theoretical model set out in a paper published in 2011 by Thomas Miceli and Kathleen Segerson of the University of Connecticut shows that when a buyer has to negotiate in sequence with sellers of contiguous plots of land, the price at each successive sale will rise. Landholders know the project cannot proceed unless the buyer acquires all the plots he needs. The more he acquires, the greater the cost of abandoning the project. The ransom those yet to sell can demand increases accordingly.

Because of the holdout problem, investments that have big public benefits will often be stymied unless a sale is forced. Laws in many countries, therefore, allow for the compulsory purchase of property (known as "eminent domain" in America), as long as those affected are justly compensated. But in developing countries, where markets for land in particular are often more regulated, less liquid and more corrupt than in the rich world, determining the appropriate compensation can be difficult.

Moreover, an optimal law would have at least one more safeguard. A transaction is efficient in the strictest sense only if it makes some better off while leaving no one worse off. Forced sellers presumably place a higher value on their property than the market price: were that not so, they might already have sold it voluntarily. Ideally, compensation should reflect this additional value. In company takeovers, after all, shareholders are usually paid a premium to give up their rights.

Such a premium would discourage excessive use of eminent domain.

India's current land-acquisition law is simultaneously too strict to pave the way for desirable projects and too lax to protect property owners. Forced land purchase requires the consent of at least 70% of affected landholders and must also pass a social-impact test. Compensation must be twice the market value for urban plots and four times for rural land. Mr Modi wants to ditch the consent and social-impact clauses for certain projects because of the delays involved. He has a point. As Maitreesh Ghatak of the London School of Economics and Parikshit Ghosh of the Delhi School of Economics point out, if farmers are adequately compensated, consent is largely irrelevant.

The price is wrong

Yet compensation in India is based on recent land sales, which are likely to be far lower than the true value of a property due to India's distorted market. The direct sale of farmland to industry is banned in several states and tricky in many others; instead, land is often sold by a farmer in distress to another farmer. Prices are under-recorded to escape high stamp duty. Appraisal is often crude, if not corrupt. A study of the Singur purchase by Mr Ghatak and others found that, though compensation was on average close to market value, landowners with superior plots were offered too little.

As long as farmers in India believe they might be ripped off, protests against land purchases by the state are likely to continue. A way to counter this, say Messrs Ghatak and Ghosh, is to invite offers to sell from landholders in a plot required for development, but also from landholders close by. A farmer within the bounds of the development who did not accept the price determined by such an auction could instead be given a nearby plot as compensation. These nearby plots would not be subject to the holdout problem as they are not essential to the project. It is not a perfect solution to India's land-acquisition issue. But it is a better one.

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