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The Code of Capital*

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Katharina Pistor:
The Code of Capital: How the Law Creates Wealth and Inequality
Princeton University Press, 2019, p. 297
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Katharina Pistor's book, which was rated one of the best publications by the Financial Times in 2019, is an interdisciplinary study. The author – currently a professor at Columbia University – received her initial education in Munich, Hamburg and Freiburg and obtained her LLM qualification in London. Although a legal expert, she wrote her work on important economic issues. According to her, *with the correct legal "coding",* any object, idea or claim *can be turned into capital,* which is then guaranteed to someone by the law protecting private property. It becomes capital in the sense that, based solely on ownership, income can be generated for the owner of a given asset in the future.

The code of capital can essentially only be enforced with the help of power, in the legal order guaranteed by it. Ownership is based on state law, but "coding" can also be a "private action", because legislation is often the result of effective lobbying. The *code of capital* can be put into practice via the legal system and institutions of the state. Legal guarantees ensure the sanctity of private property. In addition, the law can guarantee even more: for example, to protect a given asset from the claims of others against the owner, e.g. in the form of a trust, or to receive a more favourable assessment in the event of bankruptcy (e.g. for derivatives).

In Eastern Europe, generations of economists have been raised with the tools of Marxian analysis. According to this, capital is a *means of production* that – through the exploitation of labour – brings extra income to its owner. According to Marxian theory, only work creates new value. Thus, since workers receive only a fraction of the value produced, the owners of the means of production – as Marxism puts it – actually deprive workers of the value they have created.

* The papers in this issue contain the views of the authors which are not necessarily the same as the official views of the Magyar Nemzeti Bank.

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Employees are undoubtedly in a vulnerable position compared to the owners of the means of production. To this extent, there is definitely a labour-capital contrast. Workers are forced to take jobs to make a living. True, capitalists need them, but their bargaining positions are not the same. The owner of a means of production does not die of hunger tomorrow if he/she cannot find an employee... But for workers, wages provide a livelihood. The owner was in a more advantageous position even when strikes were possible during the time of organised labour and so they could put pressure on employers (one need but think of the months-long miners' strike in England, where the workers were ultimately forced to concede when the strike coffer was completely depleted).

(Money) capital, with which the means of production are bought, and thus the connection with work becomes possible, is *money-generating money.* Ultimately, legislation makes it what it is; this is what makes it suitable for income *appropriation.* Capital has never been *just a thing,* not even in pre-capitalist times: it has always been a kind of legal *relationship,* the enabling of the ability to acquire future income.

In contrast to Marx's theory of labour value, bourgeois economic theory insists on a certain "equalisation" of labour and capital, and says that the market mechanism ensures that every factor receives "its fair share". The capitalist has a means of production, whereas the worker has labour: cooperation between the two is the source of value production. Accordingly, therefore, there is no exploitation at all, only a mechanism acting by the force of natural law (which – by the way – is mediated by the *law,* in this case by contractual rights). However, there is no mention of what guarantees the fairness of distribution. In the managerial capitalism of our time, astronomical incomes are also regarded as wages, but such incomes are certainly not related to the actual performance of the persons concerned. A manager's income that is 750,000 times (!) higher than the average wages – as cited by Raghuram Rajan[1] – must certainly be considered unrealistic. Such a difference in work performance is practically impossible. Such astonishing magnitudes have never been known before anywhere – neither in England nor in Japan. There has been a maximum tenfold or up to thirtyfold difference between managerial and average wages. Obviously, in the life of a company, a lot depends on the quality of the manager. However, not *so much* by any means... Of course, it can be legal. It can be sanctified by corporate law and the labour code. Managerial "wages" are a function of the advocacy skills of the number one company manager (e.g. in a huge joint-stock company where absolute figures are relativised). Here, in fact, it is no longer the owner who shares with the employee, but the manager who dictates.[2] Who gets how much of the value created? Nowadays, an average employee usually has no serious advocacy opportunity at all, especially as the role

[1] *Fault Lines*. Princeton University Press, 2010.
[2] See Galbraith, J.K.: *Az új ipari állam (The New Industrial State).* Közgazdasági és Jogi Könyvkiadó, 1970.

of trade unions has diminished. In fact, workers in the market are vulnerable to the arbitrariness of managers and to market conditions, and now to *global* market conditions. It should be noted that when a person creates a corporate form to sell his/her work and pays himself/herself a dividend instead of a wage, the difference between wage and profit is completely blurred (this decision is influenced by which form requires less to be paid into the state coffer, and this aspect can play a role for both the employee and the employer).

First and foremost, however, it needs to be defined *what can be actually considered a capital good.* This is because capital goods do not necessarily have to be a *"means of production"* in the traditional sense. In the sense that the owned asset, or legal relationship (!) *produces money,* of course, they are. Nevertheless, it does not necessarily have to be involved in the production of *material goods.*

The concept of capital is thus an important category for distribution theory. How can the owner of a capital good receive income? And how much? *The Code of Capital* also tries to answer this question, as the author not only points to the question of *how* the coding of capital has resulted in *income disparities* today, but also to how great these *income disparities* are.

The author begins with a historical review. For centuries, land was the most important means of production. Its *ownership regulation* ensured that it would yield a return to its holder. Pistor provides an extended analysis of land ownership in ancient times, including the ways and means by which New World settlers acquired private ownership of land in America.

Today, the scope of the means of production has expanded. In our modern age, in addition to physical capital, real estate, land, machinery or intangible assets, things such as patents, royalties and brand names can become capital. What makes the issue of coding particularly exciting is that there are many different ways and means by which the law can *turn* debts, complex financial products and other assets (relationships) *into capital,* which thus provide financial benefits to their owners. The process of financial innovations and securitisation is also a phenomenon that generates intangible assets. Receivables-backed securities can be traded and income can be "produced" with them. Thus, money is "created" from a claim. Owning specific *datasets* can also become capital, as we can see today.

With captivating personal examples, the author illustrates how many things the law can turn into capital. She presents the story of Angelina Jolie, in which the celebrity had to undergo a mastectomy. She was genetically at high risk of developing breast cancer and its complications. The genetic testing option, on the basis of which this was established, was the result of a great deal of state-funded research. However, one company patented a specific process and then monopolised the market and

charged a high price for the service. While tests performed before the patent (according to processes based on state research) cost $100, after the patenting procedure, they cost as much as $3,000. It was not the company's intellectual product that actually had to be paid for by the user but one of the *nature-related laws* learned at public expense. We can see – as the author refers to it – that, by patenting, even from nature it is possible to make private capital as a source of money!

An exciting part of the book is when the author deals specifically with the analysis of the "coders", the *lawyers* and the legal systems. She points to the special power of trained lawyers. She also shows the difference between the Anglo-Saxon-type *common law* based on legal precedents and the private law stemming from Roman law, the *civil law* in force on the European continent. The Anglo-Saxon model provides a way for private lawyers to create new rights. In fact, the only limitation on this is the judge. It is up to the judge to decide whether to accept the client's position. However, in the US and England judges themselves come from the (private) lawyers faculty, so this is usually not a major obstacle for lawyers to overcome in succeeding with their cases.

In Continental law, the distinction between private law and public law is much stronger, because – as Pistor writes – in legal training, there is a separate preparation in terms of whether someone wishes to become a judge, a prosecutor or a lawyer.

One of the author's most important findings is that in modern international practice, the "pathways" between legal orders are relatively large. In the area of contract and corporate law, this process has already advanced quite far (for example, this allowed Lehman Brothers bank, which played a significant role in triggering the 2008 crisis, to set up hundreds of subsidiaries in the legal systems of different countries, companies which did not even carry out any activity or conduct any transactions). Harmonising the legal order of each country is a very slow and difficult process. As a solution, partners had the opportunity to choose under which country's law they would like to conduct their transaction.

Today, it is possible to choose *which country's legal order is applied* by private parties to an action. This is a particularly important development in the area of finance. Besides, territorial control is of little use for capital goods that lack physical form or location. This is made possible by *agreements that eliminate conflicts* between countries. As a result, New York State law and the English legal procedure became the key factor in most operations.

The ISDA (International Swaps and Derivatives Association) was formed in 1985. Without its activities, it would not have been possible to establish the global derivatives market, which operates through the financial centres of New York,

London and Tokyo (this, in turn, was the main cause of instability in the financial system). The ISDA is the most influential private organisation that creates *codes of capital* in global finance. In the case of derivatives, the Hague Conference on Private International Law established an international treaty that standardised conflict-of-law rules for financial assets. Those rules, in turn, are determined by private parties, as we have seen.

Due to the advanced standardisation, derivative amounts in the billions can also be traded over the counter (OTC). At the same time, the ISDA has managed to get some 50 countries to bring their national legislation in line with private contracts. According to this, the legal order in which the issuance took place is relevant for the ownership of the assets as well. This, too, reinforced the generalisation of English and New York State practices.

Bankruptcy law today is still essentially a national competence. To date, however, bankruptcy proceeding has not been settled for internationally active banks (the EU has recently attempted to develop a common set of rules for the banks of *the member states of the euro area;* however, other countries do not yet have such regulation). With the aforementioned agreements, most derivatives were essentially withdrawn from bankruptcy proceeding.

Patent law is, in principle, also in the hands of sovereign states. Although states have already moved towards harmonisation in the field of intellectual property rights, many detailed rules are still tied to individual states. At the same time, by concluding bilateral *investment treaties,* they have let quite a few areas go from their hands. The so-called ISDS (Investor-State Dispute Settlement), *a treaty for settling disputes between investors and the state,* has been established. Accordingly, it is permissible to submit the settlement of disputes to arbitral tribunals outside the territory of the host country. During these proceedings, the host country may also be ordered to pay damages on the basis of unfair treatment. Such an example is given by Pistor in the case of the Eli Lilly company, a patent registration of which was not accepted in Canada. According to the Canadian law, despite some changes, the renewed patent did not bring about a significant extra value compared to the original one, so it was not accepted by the Canadian authority. Referring to the investment treaty, the company challenged the decision, and demanded compensation. This led to a veritable war between the company and the Canadian state over the issue. The battle was eventually won by the Canadian state after very long litigation. In Pistor's view, the war has not yet been won... A state with less financial resources may not be able to go through this high-cost series of lawsuits. In other words, it is still not clear who is actually entitled to determine ownership, i.e. to code capital: private agents or the sovereign state.