Hey everyone, as you'll notice there's a different voice behind the microphone today.
For those of you who don't know me, my name is Roger and I'm the senior editor for the Ezra Klein Show.
Ezra is out this week for a well-deserved vacation, so he asked me to step in and host an episode in his place.
We've been doing a lot of shows recently on the current economic situation, but I wanted to make some space at the beginning of this year for a conversation that takes a step back and really tries to understand the deeper foundations of the economy we have.
So as background, one of the most basic rules of economics is that output is a product of capital and labor.
Labor is the one we're often more familiar with.
It's people and the work they do.
But if you're interested in wealth creation, then capital is really where the action is.
Capital can be a whole range of things, a piece of land, a machine or a factory, a share of a company.
It's the stuff you need to produce any kind of economic value.
And for that reason, economists generally agree that capital is the foundation of a society's wealth.
And that's what brings me to today's guest.
Katarina Pistor is a professor of comparative law and the director of the Center on Global Legal Transformation at Columbia University.
In her most recent book, which is called The Code of Capital, completely reimagines how we think about this base layer of our economy.
Pistor's argument is that capital doesn't just exist out in the world for us to use.
It's something that we actively construct through the tools of law.
And so for Pistor, economic value isn't just captured by markets.
It's actively created by the legal system.
And that's where things get really interesting, because it means that our current economy is built on top of what Pistor calls a feudal calculus.
She shows how the same legal tools developed hundreds of years ago in England to protect the rights of landlords over commoners have been applied to more and more kinds of assets over time to the point where they now undergird our entire economic system in ways that are often invisible to most of us, even as they shape so much of our lives.
So we begin this conversation where Pistoric begins with land, but we end up covering the law's role in everything from corporations to the financial system to climate change and more.
One warning before we begin.
This conversation can get a bit heady at times, and that's not an accident.
The systems we're talking about here are often intentionally designed to be complex and opaque.
But stick with it.
I got a lot out of this conversation, and I think you will too.
Katarina Pistor, welcome to the Ezra Klein Show.

Thank you very much for having me.
So your book begins with a pretty fundamental redefinition of what economists refer to as capital.
So I think that's the best place to start.
What is capital in your view, and how does it differ from the classic economist definition?
Yeah, so classically, we define capital as one of the two factors of production.
We have capital and we have labor, and both combine to produce some goods that are then sold on market.
So that's the simple story.
And I'm basically stepping back a little bit and say, well, how can some actors control stuff and decide what goes into the production process?
So they must own something.
So that's where property rights come in.
So you already have basically a legal precondition, a right to something that has to define capital.
Now, the second question is what distinguishes capital from other stuff, right?
There's a lot of stuff around.
There can be land, there can be plows, there can be cars, there can be machine.
What is capital here?
Is it just any object out there?
And I'm basically arguing that capital is an asset that has certain types of qualities or attributes.
And these attributes allow the holders of these assets to generate wealth over time or to protect wealth that they have already produced in the past.
And I offer four attributes of capital, which I then also link to specific types of legal institutions that help create capital assets.
And the four attributes are priority, which means that if there are competing claims to the same stuff, some have better rights than others.
And so the law ranks rights and claims to certain types of assets.
So having priority gives you a head start over everybody else.
The second is durability.
Durability is a legal technique to protect assets against too many different claimants.
You don't want to have too many creditors trying to get at your stuff.
So if you can use the law to separate some of your stuff out so that your personal creditors can't get it or your tax creditors can't get it, then you might have a better chance at incubating wealth over time than if you didn't have that opportunity.
So priority, durability.
The third is convertibility, and convertibility is really the way in which financial assets attain something like durability.
It's not just that you can trade financial assets or assign them, but that you have an option to convert them into something safer when things get a little rough.
So ideally, you want to have an option to convert your privately issued, privately made assets into state money in times of crisis because state money is safer.
And then you hold on to that, and once the crisis subsides, you can again invest in

the future.
So convertibility allows you, in fact, to lock in past gains by converting them into something boring but safe.
And then you go back into the more profitable assets once the crisis is over.
And then last but not least, that's really where the state really comes in is universality.
That's the fourth attribute, which says that all these legal techniques that we use to create priority, convertibility, and durability, all these claims will be enforced by the state against the world.
The key is really that it's not only that you have a contractual claim with somebody else in a bilateral relationship, but that you can count on the state helping you to protect these rights against anybody who may not have been at the table when we cut the deal and may not even know that I have better title.
But if I pull out the document that says I have better title, I get my priority right.
So we're going to explore that answer and more full throughout this conversation because there's so much sort of complexity built within it.
But let's talk through to ground this a little bit, an example of how that process happens, how an ordinary thing is turned into capital.
And I want to start with the most basic, which is, how does the law turn a piece of land into capital?
Yeah.
So land and property rights are very often conflated.
Everybody thinks that when you talk about land that, yes, of course, somebody owns it.
But just go back a little bit in history and think about all the open fields that had not been allocated to specific owners that has been true in Europe and many other parts of the world, and of course, also in North America.
Before the Cedars came, this was open space.
Many people used it, animals used it, and of course, indigenous people used the land.
But land is just basically a piece of dirt.
You can make use of it, but it's just out there and plants grow and animals use it.
And you can maybe harvest some fruit and produce from it, et cetera.
Now, when we want to monetize the land, then we need something else.
We need to allocate the right to use the land and to exclude others from that land so that the owner can reap the benefits from his or her own investments in the land.
So the enclosure movement in England, which started already in the 16th century, if not earlier, and took about 200 years to exclude the commoners as a matter of right from the land.
I mean, many still were out there and plowing the land and doing their work, but they didn't own the land anymore.
They just gave title to the landlords.
Compared to the enclosure movement, there was no clear titling system.
In fact, England established a register for land to really look up the titles only in the 1920s.
But in the 16th and 17th centuries, courts mostly decided in disputes between landlords

and commoners that the landlords had the better rights that they had priority.
So once you allocate priority, somebody can say, it's mine, it's not yours, I can exclude you, I will not allow you to graze your cattle, I will use this now to grow cash crops for the cities or I want to graze actually sheep so I can take the wool and bring it into the textile factories and I get the returns and I will not share them with you.
So turning land into capital requires a process of legal titling of recognizing priority rights to the land and vesting these rights with some agent and then the state saying, and I will back that, right?
If you now go on to the land, it's trespassing and you will be prosecuted.
So my initial response to hearing that is, isn't land like inherently valuable?
I mean, as you were saying, property rights are a fairly recent invention, but land has been providing food and shelter and resources for humanity for the entirety of our history.
And so I think the question is like, what is the law actually add here?
And I think it gets to the word you just used, which is monetization.
So you can talk about how the law enables someone to monetize land.
Like when we say they have these priority rights, they have this ability to use the land to create economic value, like what exactly are we saying?
So many objects have intrinsic value.
We might also value them because we're burying our ancestors there.
That's also another function of land.
Land has a lot of value for many people.
But for capitalism, the key is always money, making money out of the assets that you have.
And so the legal coding is about ensuring that some can make money off it and excluding others from getting their share of that money.
So what the law really does, it allows some, as I said, to exercise priority rights over the land.
And then the next step, of course, is, well, actually now we can even get more money by, for example, either selling the land, I can alienate it now.
So as long as you have commons, nobody alienates the land.
That's not what you do.
You just all share the use of the land.
You have to make sure that you have some rules in place so that nobody overuses the land.
But these mechanisms existed and still exist in many communities today.
But if you want to really make profit from the land, you have to be able to sell it.
You have to be able to mortgage it.
So that's not selling the land outright, but giving somebody else a right to take the land away from you if you can't pay back the loan that you got.
So a mortgage allows you to get more cash on your hands right now and say, I'm going to take this and go into commerce and make money by trading internationally or domestically or I'm building a factory with that money.
And I offer the land as a mortgage.
You can't do this unless you have title to the land.
And whoever the creditor that gives you the money can make sure that they can put their

hands on that land or on your house if you are unable to pay your loan.
So if you talk to any economist, there are a host of factors that they argue are really fundamental to a wealth creation and distribution.
So on the wealth creation side, if you look at an agricultural economy versus an industrialized economy versus like a service-based economy, those are all very different for a lot of reasons that have very little to do with law, right, as more to do with technology, with labor force skills and education.
And you can also say that that's true on the sort of distribution side, right?
Thomas Piketty in his most recent book makes a very convincing argument that the so-called great compression of wealth in Western democracies during the 20th century was a product of the rise of progressive taxation and the welfare state.
So in this broader story of wealth creation, of wealth redistribution, where does this process of coding capital fit in?
How does it relate to these other factors and what about it is distinct?
The real distinction is between whether we're talking about redistribution at the back end or the creation of wealth at the front end.
And I'm interested in the front end.
I want to show first how wealth is being created and then also think about whether the typical policy advice like taxation is actually an effective tool to deal with the wealth creation at the front end.
So economists, because they believe that ultimately it's the markets and better skills and better know-how and better resource management is what produces wealth, they're less concerned with the pre-distribution.
And I'm basically saying the creation of wealth itself is already a process by which some harness the legal system, which is actually not a private good, but a social resource to produce their private wealth.
So what they're creating already has basically the DNA of a social structure built into that.
And I really like to think about the coding of capital as the code being something akin to the DNA, the genetic code or akin to a software code.
That's really how the stuff is made.
The law is the source from which capital is cut.
If you understand this, then you have to say, okay, at the back end, we want to do some redistribution.
I'm all for redistribution also, especially given the amount of inequality we have today.
But unless we think about the creation of wealth and how inequality is being created through law in my argument, we will never get ahead of the game.
We might do some redistribution now, as we've done in the golden age of the 1960s, 70s, when the state actually did tax.
And then taxation will be pushed back again, and inequality will come back, and we haven't still figured out how to really deal with inequality at the front end.
So I'm basically saying let's just start looking at how wealth is created, and then we can decide what policy tools do we want to use to minimize inequality or at least keep some check on it, and whether redistribution is the best means to achieve that.

I think that's a really helpful distinction.
So let's talk about what that structure, that DNA, actually looks like.
We've already spoken a bit about land and property rights, but give me a sense of the range of legal structures we're talking about here, and how those structures help create wealth.
So I basically call the means by which we turn simple assets into capital assets modules.
So I talked already about the attributes that law confers on assets, but the way it's done, we need some legal institutions.
We basically need property rights.
We need collateral law mortgages.
We need some contract law.
On top of that, we very often also use the common law trust or corporate law, and to some extent other areas of the law, such as bankruptcy, can be used as well.
But what is really interesting when you look at the creation of capital from starting with land all the way today to the most complex financial assets, when you look at the legal DNA, it's all the same stuff.
So you said before, agricultural economies are different from service economies are different from industrial economies, post-industrial economies, et cetera.
Yes, that's true, that's the outer appearance of these systems.
But when you look at the making of the DNA, the structures that create wealth, it's always the same stuff.
It's property rights, priority, that's the attribute that you confer with it.
It's the use of corporate law trust law to create durability for some assets that you separate out from others, and you create basically a separate legal vessel that many people cannot penetrate to say these assets can incubate over time, so they create wealth.
So that's a durability, or you give some an option to convert their assets into save money when the sailing gets rough.
And on the back end of it, the state says, whatever you do, however you code, capital with the legal tools that you have, I will lend you the coercive powers of the state, and you can go to court and enforce your claims, and we can call in the bailiffs and the police if necessary to enforce these claims.
Without that enforcement capacity, you wouldn't be able to have large-scale markets.
Why should I take any empty promise from a person I've never met at the other end of the world working in a different time zone that he or she will actually live up to the commitments, to the promise to pay in the future?
I want to have an enforceable rights, otherwise I'm not trading.
And so these are the things that we never make explicit when we talk about the system that we have, is how we create these commitment devices that economists like to talk about, but they don't look into the legal structures that really create them.
And what I'm trying to do is to dissect, I'm just always thinking like it's an institutional autopsy.
I'm going inside these assets, I'm looking at the legal structures, I'm trying to bring them to the fore for people to understand how the stuff is really made.

So I want to talk about one of the stories that you mentioned there and that you traced throughout the book, which is you argue that these same basic mechanisms that were first used to turn land into capital have over time been applied to more and more kinds of assets, oftentimes increasingly abstract assets, and that that process has really given us the economy we have today.
And we're going to dig into some of the specific pieces of that, but could you just walk me through that story at a high level?
Yeah, so we started off with land because land actually was the most important source of wealth in the industrialized countries until the very end of the 19th century, sometimes even bleeding into the 20th century.
So it all started with land.
But even as land was turned into capital assets, as property rights were created and it was more encouraged to erase credit, etc., already other assets were being turned into capital, for example, intellectual property rights.
So with intellectual property rights, I think it should be self-evident that even the stuff itself, the asset itself, is actually a creature of the law.
There is no intellectual property right unless we say we recognize a certain invention as patentable, and then you have to patent it, otherwise you can't tell others you can't use this.
I was first, and I now have a monopoly for the next 20 years or so, to use this invention.
So intellectual property rights have to be created, patents, copyrights, trademarks are legal inventions.
Financial assets as well are intangible.
They are creatures of the law.
Every financial asset is an IOU, an enforceable IOU if it shall have value.
So it's a contract.
And then we dress it up with collateral and we turn what used to be like a contractual claim for future payment.
We treat it as if it was an asset, as if it was a property right.
And with these additional attributes, we're creating something that is actually valuable in monetary terms that you can sell for a lot of money and you can reap the profits.
I'm not really telling a story that is just a sequential story, first came land and then came this, then came that.
I think there are a lot of parallels.
You can go back to Venice in the 15th century and you have the first statue that protects patents.
So you get this relatively early on, or Queen Elizabeth allocating monopoly rights to the inventors or certain new machines.
So you get that in parallel to the enclosure movement of land.
But the technique, once it was discovered that this is what you can do, you can take a law and to give people priority rights over everybody else.
You allow them to separate assets.
You create the first trading companies.

Then people mimic this and they use it for different assets.
Capitalism is all about expansion, finding new resources.
And the resources don't have to be in nature.
The beauty of the law is actually you can just make it up and then you can make a lot more of this.
I think we shouldn't be surprised that financial capitalism caps the centuries-old evolution of capitalism because you just make that through contracts, through legal techniques.
And you have a new capital asset that you try to market.
There must be a demand for it.
But without the attributes, there wouldn't be a demand for it at all.
And then you have another source for wealth creation.
Yeah.
And this really gets to a paradox or a contradiction that I think really exists throughout your work, which is this idea that the law is really this sort of miracle.
It's allowed us, to your point, through these legal fictions, scale up society from the level of smaller tribes, these big, complex economies.
But at the same time, these legal fictions are one, when it comes to the enclosure movement and the ethnic cleansing of Native Americans are built on some really horrific injustices and also are responsible for a lot of the inequality we have today.
So I just want to flag it.
I think that is a paradox that we're going to come back to throughout this conversation.
And I want to start with some specific examples of this.
You mentioned IP law, you mentioned financial assets, and we're going to get into those.
But I actually want to begin with corporations.
So tell me about limited liability.
What is it, first of all, and what purpose did it originally serve?
And maybe you can even start with the way that that law creates corporations in the first place, because that's not always intuitive to people.
Yeah.
You know, just like with land, I said before, you can think of land as a piece of dirt, but it becomes a capital asset only once you add property rights.
So for me, you always have to distinguish between the simple thing, the stuff that we can look at or think about, and then the legal coding.
And the same is true with a firm.
You can just run a little mom and pop shop, a little start-up with a couple of friends, and you don't even have to go anywhere and register.
You just have your little firm.
The law might treat you in a certain way if you do something for profit, but that's another story.
If, however, you want to create a separate legal entity that owns its own assets and contracts and its own name and can sue and be sued in its own name, then you need to be more.
You can't just invent this.

It has to be recognized by the law, which means you have to at least register it.
So when you think of a corporation, you have to think of a couple of things.
First, you create a separate legal person.
We call them legal persons.
They are treated very often like natural persons, but they're creatures of the law.
They can't exist outside the law.
There are legal fictions, as you call it, but I think it's just not that fictitious.
We have lots of corporations that dominate our lives, so you really have to take them very seriously.
But it's an important fiction to say it's separate from you.
It's separate from the founders.
It's separate from the owners.
It's separate from the management.
Indeed, today, corporations typically have an infinite lifespan.
They live much longer than any of us, any of their managers, any of their employees, any of their financial investors.
That sort of gives them staying power.
That's durability in my classification.
So limited liability was a technique that was invented, and of course, investors wanted it.
The state says, actually, if you comply with some basic ground rules, you can set up a corporation that is separate from you and gives you, as a default provision, limited liability, which means that if the company goes belly up, nobody can get to your personal assets.
So you can say, this is risk diversification.
It also allows you to broaden access to capital because small households and small savers would never put their money into a company if the creditors of the company could put their hands on their own personal assets.
That's too risky for them.
So if you want to have many people just blindly putting their money into a corporate sector, you have to give them limited liability.
And by doing so, you're basically giving the investors, the shareholders, a license to externalize the risk because they can invest in the company no matter what it does to others, but they can't lose ever more than the money they put into the company.
You can lose your money that you use to buy your share, but nobody can go after your own personal assets.
And that sort of changes the game, of course, for firms and investments and risk-taking in capitalist economies.
I think something that really stands out from that answer is that when these mechanisms, like limited liability, are created, and you can say a similar thing about the corporate form itself, it sort of makes sense.
Limited liability, as you're talking about, incentivizes, at least in some cases, or maybe at least originally, a healthy level of risk-taking.

Imagine how daunting it would be to start a business or be an early investor in one.
If you knew that if the business failed, you would lose your house, you could lose your car, your retirement savings.
I mean, it's hard to imagine a lot of people would want to do that unless you have this sort of legal tool, and so you can understand why it would actually be really important to get economies off the ground.
But an argument you make in the book is that in recent decades especially, limited liability has sort of morphed into a mechanism through which already wealthy shareholders can shift their losses onto other actors.
So can you talk to me, and maybe you can talk through some specific examples of how limited liability is often used in that way to sort of shift losses onto others?
Yeah.
So I think in general, this is already what this device is all about, right?
I don't have to face the losses to somebody else has to.
What this means, in fact, is that if the company goes belly up, there will always be losers.
The workers will lose their job, and especially the creditors who might have also put money into the company.
They don't get anything if the company has no assets left, right?
Very often in a corporate bankruptcy, creditors get a couple of cents on the dollar that they had put into the company, and they can't go back to the shareholders, right?
It's a redistribution of risk in a way, you're shifting it to the creditors just by the invention of limited liability.
But then you can also start to become more adventurous, right?
Especially once most legal systems allowed corporations to procreate, so if a corporation can create another corporation.
So I'm a parent company, I just said a couple of subsidiaries or daughter companies.
In the US, it was highly disputed throughout the 19th century, and only towards the end of the 19th century did states allow in their corporate laws, corporations to create other corporations.
Once you do this, you say, oh, this is great.
I can now, I'm the parent company, I raise money on capital markets.
That's debt finance for me, but now I have cash on hand with which I can capitalize.
Another entity, a limited liability company, I keep 100% of the stock.
This company now has some assets.
And then they use the assets to borrow against by raising again capital on markets.
And the beauty is if this subsidiary goes under, well, I have a legal shield between me and the subsidiary because the subsidiary is another independent legal person, and the creditors of that independent legal person can't come back and try to get my ass.
The example that I used in the book to make this visible is Lehman Brothers, the beauty of a bankruptcy.
And of course, Lehman went under in 2008.
The beauty of a bankruptcy is that all of a sudden we can look inside.
We get all the documentation from the bankruptcy receiver, all the details that might have

been difficult to assemble while the company was still in motion.
We get this once you have it on the autopsy table in your dissection room.
And if you look at Lehman when it failed, it had hundreds, if not thousands, of different legal entities.
For sure that could be documented over 200 separate legal entities, 60 of them alone in Delaware where the parent company was incorporated as well, 30 or so in the UK, another 34 in the Cayman Islands, some in France, Germany, Japan, so hundreds of these subsidiaries.
And so you have to ask yourself, why do they use that?
And it's not because they have to create separate subsidiaries in different jurisdictions.
They want to, otherwise you wouldn't have 16 in a single jurisdiction.
And I think the logic behind that is that they use the technique I just described.
They're basically saying, we can probably raise more debt finance as a group if we separate it out between different entities and play a couple of additional tricks.
So one thing they did, and that is a risky exercise, but they did it.
And maybe also it's one of the reasons why the company failed, they said, okay, we create a parent company, then we have all these other family members, these children that we create the subsidiaries.
They all go out and raise funds for their specific investment project, for their specific new financial asset or activity that they want to conduct.
Meanwhile, the shareholders of the parent companies, the ultimate investors at the top of the entire group, they're getting every penny of profit that the group generates by getting this paid out in either in the form of dividends, or they just engage in repurchase programs of shares.
So companies have done this for a long time, financial intermediaries even for longer, that they repurchase their own stock, which is a way to give their shareholders their money back.
And then the shareholders can decide whether they want to rebuy shares in this company or go somewhere else.
The shareholders at the top, they of course benefit from limited liability.
They get all the cash that comes in, they will not be exposed to any losses if anything fails.
And now you get the change in the market conditions and the housing markets and global financial markets.
And all of a sudden, one subsidiary starts to get a little wobbly, and another gets a little wobbly, and creditors of these subsidiaries are saying, okay, where do I get my money?
That subsidiary will not pay.
So let me go to the parent.
What are the assets the parent has?
Well, it shares on the subsidiaries.
And so you see at the end of the day, you have a house of cards, which created an enormous amount of profits for shareholders over time that took off millions, if not billions of dollars.
But when push came to shove, when you look to bankruptcy, not all that much was left

at the end of the day.
But looking at the structure, I think you can also see why not that much had been left at the end of the day.
I find this example to be just infuriating.
To put some numbers to this, you point out in the book that in the time period from when the housing market began its downturn in 2006, until its collapse in 2008, Lehman Brothers paid $631 million to its shareholders.
And that was the low end, Wells Fargo paid $10 billion, JP Morgan, $11 billion, Citigroup close to $16 billion.
And when you think about the incentive system at work here, it's just shocking, right?
Like, all of this money is being paid out at the same time that the economy is beginning to fall apart in a serious way.
And so at the same time, these banks most need to be building up a financial cushion to absorb potential losses, they're doing the opposite.
And I think that's such an important point for understanding why 2008 got as bad as it did.
You hear all the time in the context of that crisis about the banks being quote unquote too big to fail, as if it was some inevitability.
But it seems like one reason they were so overleveraged in the first place is because of this bizarre incentive system you just described.
And so I guess my question is, when the financial crisis did hit, what actually happened to that money?
And who ended up paying the bill at the end of the day when many of those banks either plummeted or outright collapsed?
I mean, the money that you just mentioned was, of course, paid out to the shareholders, which are investors.
These can be pension funds, these can be other institutional investors, maybe also some private investors.
But this is a whole range of investors.
They, of course, cash the money, they probably reinvested it into other ventures.
So that money is basically being circulated in the economy.
Now, the problem is if the entire market starts wobbling, policymakers face a stark choice.
Many economists and some more libertarian politicians also were saying at the time, let the market just crash.
They need to learn their lesson.
And we'll just have to go through this.
And the market will allocate the losses where it falls.
That's, of course, a proposition that risk tanking the entire financial system, which is the nervous system of our entire economy.
So if the financial system collapses, you won't be able to pay your employers the next day.
Most people won't have access to their own savings easily.
There might be runs not only on asset markets.

As we have seen, there might also be more runs on banks.
There were a couple of major bank runs in the UK and other countries, even if there were not physical bank runs in this country, but there were runs on assets.
If policymakers say, we'll just allow for a self-correction of markets, this risk basically a major collapse of the financial system and the economic system on a scale that we've seen last during the Great Depression in the United States or in other countries like in my own home country in Germany, it was one of the causes for fascism to rise.
So it's also a politically risky proposition to allow the economy to tank.
And so what do you do if you don't want to allow it to tank?
You have to try to stabilize the economy.
And so you're throwing money at the system.
What money?
No state money.
As I said before, state money is safe because the state stands behind it and basically promises the future productivity of the country to say, we stand behind that money, we issue it.
And we give it, we give liquidity boosts to the core institutions in the system without which the system as it currently stands cannot operate.
So they tend to rescue the system at the top, at the apex or the core of the system because that's where the real risk is that it might collapse.
They're basically throwing money at the same institutions that created the risk in the first place that caused the financial collapse.
But they almost don't have a choice.
One can debate, of course, whether they could have saved the homeowners and then indirectly through them the banks.
But what they did, they just threw the money at the banks and did other critical institutions such as AIG.
Many people will remember the AIG bailout that followed after our Lehman Brothers collapsed.
And in this way, I think it becomes visible how central the state is for maintaining the kind of financial system we have today.
Because without that backstopping function, it would have very likely collapsed.
I'm Lulu Garcia Navarro, the host of First Person from New York Times Opinion.
On the show, I talk to all sorts of people about the experiences that shape their beliefs.
Some of my friends got shamed and called out in school board meetings.
You start wondering, oh, is this going to happen to me?
Beliefs that can be polarizing, but the emotions behind them are central to understanding the world we live in.
Oh, yeah, I've had my concealed weapon and I've had a gun on me.
But now in my later age, switching over to a classroom, that's a whole new ball game.
I want to explore opinion in all of its complexity, and every opinion starts with a story.
I'm going to ask you this because this is like a very volatile period, and you decide to become a politician.
I really want to understand how that happened.
I mean, what inspired you to run for office?

First Person from New York Times Opinion.
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I want to talk about a related example here, which is the way that the same legal tools that were originally used to turn land into capital, that we've been talking about creating legal persons in the form of corporations, how those same tools have been used more recently to turn debt itself into capital.
Can you sort of walk me through how that happened?
Yeah, I mean, a debt claim is when you start with just a simple promise by the data to the creditor to make a payment in the future.
So for the creditor, it could just be like a relationship of trust, I give you some money, you promise me to pay back and that's it.
But for the credit again to make money with this, the promise of the data has to be tradable because then they can cash it in now, they can sell it, and so they can have the own liquidity to invest again in other things.
And the entire business of banking is based on the idea that we can give credit and basically create debt for some and make money on that.
And so our entire financial system is a system that has created legal devices to basically dislodge financial relations from the basic interpersonal trust relation to give them the legal backing so that lots of people take promises and start doing other things with them.
So on the basis of that promised money, you make your own investments, right?
It's a house of cards if you want, but it works as long as most people believe that most people will eventually pay back their loans and as long as that is true, the financial system remains stable.
Once this is no longer true, then it becomes a very risky proposition.
So let's walk through an example here, the mortgage-backed security.
You call the mortgage-backed security, quote, the quintessential legal steroid, end quote.
So first of all, what is a mortgage-backed security at a high level and how does the law construct them?
So a mortgage started with this before we securitize it.
A mortgage is basically the offering of an additional asset to back the promise to repay.
So I buy a house, I don't have enough cash on hand to pay the price, I need a loan.
The bank gives me a loan or a broker or organizes a loan for me if I offer the house as collateral as it gives them a mortgage, right?
So that's the simple story.
Now in the past until the 1970s, the early 1970s in this country and many other countries as well, most banks would basically lend to local homeowners and then they would sit on these mortgages for up to 30 years and hoping that the homeowner will actually pay month by month the money that is owed, which is basically the principal plus interest.
And if he doesn't pay, then we go and evict and seize the house, right?
That's the mechanism.
Now the idea was born and that was actually a political idea, there were sort of private law creations prior to that.

But it was a decision by Congress to say in the late 1960s, why don't we allow the big mortgage companies, Fannie Mae in particular, which was a government-owned company first, later privatized by the government-sponsored company, why don't we allow them to start securitizing mortgages because it allows us to broaden the creditor base and it will bring down the cost of credit and so more people can buy houses, which is a great idea, right?
So he basically saying, okay, the private banks, the private brokers originate mortgages as before, they give a loan, they take a collateral in return and then they do this over and over and over again, they take an entire package of loans backed by mortgages and they sale the whole stuff to Fannie Mae or Ginny Mae, one of the government-sponsored or government-owned
entities and then they securitize it.
So they just pack it up and what do they do?
They throw it behind the wheel of a trust, which is basically creating a separate legal asset pool and then sell interest in this asset pool to investors.
And now these investors don't own a specific mortgage or the loan, the cash flow that comes from the loan backed by a mortgage, but they own a cross-section of the entire pool.
And in the beginning, this is what it was, it was basically a cross-section of the entire pool in a particular trust structure that had all these securitized mortgages in them.
So the securitization basically means you are flipping a claim to future pay into a financial asset that you can trade.
So you're selling these interest in the pool to different investors who can also resell them if they want.
So they can always diversify their portfolio, reconfigure it as they please, and so many more investors will join the market.
That was the original model and I think it was a very good model.
Now, then this model of course morphed as well because at some point the government also felt that maybe the private sector can take over securitization.
So you started having collaborative securitization projects and eventually the private sector took over, but then they also took the system for a ride.
They basically said, this is ingenious.
You basically you take promises to future pay, any kind of receivables, you package them up behind a trust structure and you can just trust, you can just easily create, it doesn't even need a governance structure, it just needs a trustee to make some decisions on behalf of the beneficiaries, which are the investors.
And you can thereby always get cheaper credit because so many more investors will jump at that because it's just a portion of the risk that they take and so they will give you money and you can just build the entire system.
And so you have, if you look at the modules of the Code of Capital that I mentioned before, you need property rights, you need trust, you need corporate law, you need collateral law, you need contract law, you have all of that built up into these systems.
A mortgage is of course based on property rights and collateral law.
For securitization, you need trust because you separate the mortgages and the loans of a certain pool of homeowners into one vehicle and then you sell interest into that vehicle

to all kinds of different investors.
And then on top of that, the legislature also created both tax incentives and priority rules and bankruptcy that made it even more attractive for investors to go into these kind of securitized loans rather than into direct loans that didn't have similar benefits.
So you're basically creating a legal structure that makes it apparently less risky to be in these kind of assets rather than in anything else.
The problem is if you overdo it, if everybody just then starts humming out more and more securitized mortgages, the question is what is the quality of the houses, what is the quality of the boroughs, can they actually really pay back?
And as you know, many books have been written about this about the mortgage crisis.
The brokers that originated the loans were no longer looking at whether people had actually a job, were able to pay their loans, but didn't matter because you just generate the fees, you create these new structures, they're investors who want to buy it, it's all fine until it's no longer fine because people realize that actually the cash flow is not coming.
And then everybody's starting to say, okay, where are my rights?
What rights do I have?
Can I actually seize the house?
Can I get cash flow from this house to put it back into the structures and pay it to the investors?
And if investors feeling actually this is no longer working, they're going to sell, that's exit.
And if too many exit, you just drive down the price of these assets.
And so in a way, would it be fair to say that part of what these legal coding devices, like the mortgage-backed security or at least how it's used today, part of what these devices are doing, it's not necessarily guaranteeing convertibility.
It's giving the illusion of convertibility.
It's creating sort of what you can think of as like a liquidity illusion.
These legal structures, the mortgage-backed securities, the CDOs that were built out of them, it seems like what you're describing is that they promise a level of stability, a level of convertibility, ability to cash out that they can't ultimately keep, that at the end of the day, there's no guarantee you can cash out.
But these structures are dressed up to make it seem like if you can, and because these assets appear way safer than they are, that causes more money to enter the system than it can handle and you get a bubble.
Is that a fair way of describing it?
Yes, that's exactly right.
I fully agree.
And so I think this brings us to one of the such arguments in the book, which is we can sort of sit here and rehash the 2008 financial crisis all day.
But what I think you're offering here is actually a much broader theory of financial crises, almost legal theory of financial crises.
Could you just talk me through sort of your theory of how and why financial crises happen?
Yes, and I actually did publish a paper which is called A Legal Theory of Finance, which

was in response to the global financial crisis of 2008, because I had the very strong feeling during the crisis and afterwards is that nobody really had a good theory on offer of how the financial system works, why it crashed.
And I don't think anybody can predict when it will crash, but just at having a coherent explanation for both how it expands and why it so frequently crashed or becomes highly unstable.
My feeling was that neither modern finance theory nor many sociological accounts could really give us a fuller picture.
And the legal theory of finance was really a product of a collaborative research project with sociologists and political scientists and economists and some lawyers as well.
And the lessons that I got from this research project where we looked into different types of financial markets in the decade running up to the global financial crisis and said, let's just say, what happened?
Let's look at existing theories and see what they explain and when the explanation collapses.
And then let's try to learn from that.
That's how I basically tried to learn to myself in the end how important the role of law is.
And when I look at the financial system, I'm basically saying it's deeply legally structured, which others have said as well.
It's just maybe a little bit more fine-tuned in the way that I say it.
So you can't have highly-scaled financial system without the law.
You can have local promises among people who know each other.
We know in the Middle Ages, you had trade and the Mediterranean, but it was held together by a group of ethnically homogeneous middlemen.
And the scope of the financial market was limited by that network.
If you didn't have clan members of these middlemen somewhere in a port at the edge of the Mediterranean, you wouldn't trade there because you had to rely on these middlemen.
Now the beauty of the law, when you basically create authority of the law backed by state power, you can actually create a global financial system as long as you create the contractual and property rights devices such that claims will be enforceable not only in the single court of law, maybe actually in multiple courts of law, but you create this additional backstopping mechanism.
So to have national markets, especially financial markets, to have global financial markets, you need the law to scale it.
The problem is that once you have created all these credible commitments and they're credible because they're in principle legally enforceable, you dress them up with collateral.
You say, I have a really, really good asset and nothing can happen because it's not only the promise, it's also the asset that backs it.
But at the end of the day, if everybody tries to enforce their rights at the same time, then the system necessarily collapses because it always creates more promises that it can keep.
That's the very idea of credit.
I'm saying, you get this in the future once I get my return and making a promise on the future hoping that the future will turn out better than the present currently is.

Even if everything else just stays the same, we're trying to enforce all the rights at the same time, the system must collapse.
That's the very source of the system is promises that are in part empty.
And when you get changes in circumstances such as changes in housing markets, changes in the volatility of financial markets and the stability of financial intermediaries, then everybody will start looking a little closer.
And so the law and finance paradox basically says, you need law to build financial markets, but the law will also destroy financial markets because if you actually enforce all these commitments, you will self-destroy the system because there are not enough assets to back all the promises that you made.
Now, at this point, you have to step out of the legal system to avoid the crisis.
And that's basically you go offline if you want, you offer support to the financial system, whereas there's actually no legal claim.
There's no right to have this liquidity at the discretion of the central bank or the treasury or other policy institutions to say, we actually put liquidity where no liquidity was owed into the system to stabilize the system as such.
And now you have the question, actually, can we go back to the status quo and can we go back to the big again?
And it's actually law is such a great credible commitment device because now you know that actually if you enforce all legal commitments, then we need actually a backstopping mechanism without it.
It doesn't work.
And I think we have reached a stage in financial market development where most sophisticated players know, of course, that the system is inherently volatile and will collapse if all promises were enforced at the same time.
You just go for another ride.
You're trying to safeguard your claims a little bit better than what your competitors might be able to do in the last instance, you just have to pray that the Fed will step in if things go wrong.
And that really connects something for me about your work because another way of telling the story of increased financial risk taking over the past few decades is that it was precipitated not by law, but by the Fed's conditioning of markets.
So in 2008, there was a belief that the banks were too big to fail, that if everything collapsed the Fed would have to bail them out.
And partly as a result, it did.
But what you're saying is that part of the reason the system was too big to fail in the first place that the Fed had to step in and condition markets in this way was because of the way that law has constructed a system that is over leveraged, that invites more risk taking, that is this house of cards that could easily collapse on itself.
I'm just wondering if that's correct and if that's how you think about how those two stories interact.
Yes, I think there is clearly an interaction because I think the more the market understands that the Fed will have to step in, the greater the risks will be that the markets will take.

But blaming the Fed or any central bank for that, I think puts the card before the horse
because you have to think about first how the risk in the system is being built up.
So I think again, it's like we talked about earlier about what is pre-distribution and
redistribution, where does this all come from?
And I want to first understand the sources of the instability, the inherent instability
of finance, and then think about what is the role of a central bank in the system.
And what I would argue is that we've actually used the legal tools not only to make sophisticated
banking or make banking more sophisticated over the last couple of decades.
Remember that an entire shadow banking system was created in that period, which even today
rivals the regulated banking system.
So when credit markets first demonstrated that they can destabilize entire financial
system, countries, England, the United States, many other countries started to regulate banks
and they thought, okay, now we regulate banks, now the system is safe.
And of course, competitive markets will try to find avenues where they can do the same
stuff that banks do in ways that they will not face the cost of regulation.
So they engage in regulatory and legal arbitrage, and shadow banking is that system.
And the system of mortgage-backed securities that I described earlier is part of the shadow
banking system.
You have to add a couple of additional elements to it.
So you have these assets, mortgage-backed securities, or other securitized assets.
You have intermediaries that originate them, you have intermediaries that manage them,
you have some investors who buy them like pension funds, you have money market funds
that offer liquidity to them in good times.
So you have an entire ecology of new institutions that come out and they do functionally exactly
what banks do, but they were not regulated as banks.
Now, as long as you allow this to morph, and I think Congress can be blamed to some extent
also the Fed and the regulators can be blamed to allow the system to morph and to scale up
when then a financial crisis appears as it must at some point because you're making promise.
So it's on a future with the expectation that the future will always look better than the
present and that is just not going to happen.
So at some point the system will start to unravel and then the question is, yeah, can
we allow it to crash?
If it is too big, the political, social, economic cost of allowing it to crash can be enormous
and are unpredictable.
And at this moment that I think it's very hard to argue that the Fed or the central
banks that had the capacity to try to rescue the system shouldn't have done that.
It's the build-up of the system, the inability to control, the unwillingness to control the
build-up because we're saying, oh, that's the market, everything the markets are doing
is just fine that I think prevents us from trying to monitor what's going on and maybe
intervening earlier before the build-up is too big for not intervening.
I think one of the possibly frightening questions that that raises is whether we're in one
of those build-ups or one of those crashes right now.
A lot of economists and economic historians have been talking about the way that we're

living through this moment of particular financial fragility.
We've had a couple of them on the show.
People can listen to our episodes with Adam Tooze and Muhammad El-Aryan.
The point that they've been making is that our financial system has been built on top of an assumption of low interest rates, of cheap debt financing, of quantitative easing for a while now, and now that that's being taken away, it's going to create breakages in the system.
It's going to reveal some of these cracks in the system, as we saw with the UK gilt markets a few months ago.
I'm just wondering, as someone who has studied these systems closely, do you think we're in one of those pre-2008 moments right now, and are there any parts of the economy or financial markets that you're particularly worried about?
I do think that we are in a moment where things become relatively volatile, dangerous, and to some extent unpredictable.
I think the one thing that one could predict is that it's crisis-prone.
The reason is, I think, the build-up of leverage in the system, which I think has been sort of controlled with the banks, at least the official story, although recent news reports have suggested that banks have reached similar leverage levels that they had last before the 2008 crisis, so that's not a good sign.
On top of that, we've seen many of the practices for creating the mortgage-backed securities markets, for creating shadow banking.
We have seen many of these practices also morph to the non-financial sector.
We're using similar techniques to find debt finance for large corporations that are in trouble.
We're building exactly the same kind of mechanisms that I described earlier for Lehman Brothers, so that many of the ordinary corporations in these countries are also levered up.
Now, they might not be as systemically volatile as financial intermediaries, but it's important to keep this in mind because they might be affected just as the car companies had been.
In 2008, there might be more other non-financial companies that might be affected.
I think building up of leverage in the economy is always a sign of potential trouble in the future, especially when you can't locate it very easily and when many different entities are involved in the production of credit might be exposed to the risk that will unfold.
That's basically a question of time.
I don't think you can predict exactly when it's going to happen, necessarily not where exactly it's going to happen.
You can pinpoint some of the most volatile sectors, and mostly I think it will always be in relatively small entity on the periphery of the system that is cut off all of a sudden from refinancing, and then the risk will spread because more and more will then look a little closer at what's going to happen, and the system then builds typically from the periphery to the core.
I think we are in a moment that we have to watch closely, and I think the central banks right now are in a bind because on the one hand, they're trying to control inflation and trying to raise interest rates.

On the other hand, by raising interest rates, they will have an effect on a financial system that has been built around low interest rates, as you suggested, that is largely unpredictable.
So far, we've mainly been discussing the way these legal coding devices have been applied to different assets over time.
But another trend you track in the book is the way that as our economy has globalized, corporations have increasingly been able to functionally choose which country's domestic law that they want to follow.
And for me, one of the most unsettling but also revealing examples of what incentives begin to take shape when this happens is the Rascals program operating out of Lehman Brothers.
So can you talk about what Rascals was and the purpose that it served?
Yes, this is one of the little anecdotes that I like to tell because it gives you, I think, so much insight in how the system really operates and also maybe the mindset of the people who are doing it.
So Rascals stands for regulation, administration of safe custody and local settlement.
If you think about this, it doesn't really translate easily into the acronym Rascals.
So let me stack back a little bit.
Lehman Brothers, as I said before, it's an American investment bank.
It has hundreds of subsidiaries.
One of its most important subsidiaries was one of the entities working out of London, which did most of the trading insecurities for the entire group.
At some point, the European Union came in and decided that it had to make financial markets a little bit more stable by requiring all intermediaries, not just bank, but also investment banks like Lehman, to hold sufficient equity capital against lending, against basically being exposed to borrowers who might not be able to pay back in time.
So that put the Lehman Brothers business model at risk because it became more expensive to do their job because they couldn't now borrow or basically raise debt finance on markets and then just use this for their trading and lending, et cetera, activities, but they always had to keep some back, if you wish, to make sure that there was enough equity backing of their activities.
And so they thought, how can we lower the regulatory cost of these?
No measure.
They can't just wiggle out of this unless they want to get out of London, which of course they don't want to because London is the hub where they want to be.
So what did they do?
They set up an entity in a jurisdiction that was not governed by the EU rules, Switzerland.
Now they didn't have to move to Zurich.
They could just set up in London in the same office, run by the same people, a separate legal entity that was governed by Swiss law.
And Switzerland, of course, has access to EU markets, but it's not regulated by the same regulatory principles.
Now the key was to make sure that legally speaking, the exposure, the risk exposure that their EU regulation was trying to get it, would always rest with a Swiss entity, not with a London one, because that way you could basically get around the requirement to hold

additional capital against this exposure.
And so they set up this repurchase program.
So Repose is just a device to say, I sell you something and you sell it back to me tomorrow at a higher price, right?
So what they did, they set up an automated system that these repo transactions would never close, so you open a leg, you get the payment back, immediately you open another leg and you shift the asset back to the Swiss entity, so that the appearance was created that nonstop the Swiss entity would have the exposure, not the London entity.
And so you wouldn't have to take the capital charges at the London entity.
It was an automated system.
The big irony was that after Lehman had filed for bankruptcy and all the other Lehman entities also filed for bankruptcy, nobody had bothered to switch off the system.
It was still running until some employee without ask and just switched it off.
And then there were 50 million where there was a legal dispute.
Who gets it?
Who gets that money?
Does it belong to the London entity, to the Swiss entity?
And of course now both are in bankruptcy so that the creditors of these entities want to claw back the money wherever they can find it, so they get anything back from the money they put into these entities.
And so they fought, the receivers in bankruptcy fought over who should get this money.
In the end, the London entity won for reasons I don't find entirely persuasive, but that's what the chancellor in England decided.
This example is just so maddening because earlier when we were talking about these dynamics of financial crises, we were talking about what you would ideally want is for the state to step in with some form of regulation to be able to prevent these kinds of dynamics from building up in the system to the first place.
And in many ways, that's what the EU did or at least tried to do.
They tried to create these capital requirements and instead of following them, Lehman was able to just completely circumvent them and keep going almost as if normal.
And so I guess the question is, one, how is this legal?
And two, if this is legal, if this is something that companies can just do, then what does that imply for the possibility of regulation in a sort of globalized world?
Yeah, I think these are really important questions.
So is it legal?
Well, that's of course the artwork that lawyers have to provide.
They have to make sure it's legal, otherwise it doesn't work, right?
One of the lawyers I very often invite to co-teach a class with me is sort of a leading partner in the city, and she describes to my students always that you have to think about the regulatory regime as the scaffolding, and in order to create a new asset that works, you have to find a gap within the scaffolding.
Because if you hit one of the scaffolds, it's void, you can't enforce it, it doesn't do any good for you.

So you have to design something that is at least formally legal.
And if it is challenged sometimes in the future, maybe somebody will say, well, it violates the purpose of the law, but that's just down the line.
We don't even know whether anybody will ever be challenged.
So I think what is important to understand here is we have actually two legal systems folded into one.
We have a system of private law, which is designed to give private parties a lot of autonomy and flexibility to design their own legal arrangements, to take a contract and refashion it, to create a corporation and do things with it that help them advance their specific interest.
It's a highly malleable system, but it has the blanket guarantee that if you do this roughly within the parameters set by the law and there are a few mandatory rules in private law, it's all dispositive.
People can do a lot of stuff with that.
It will be backed by the state.
And then you have the regulatory system that comes in from time to time.
It says, actually, maybe they've gone a little far.
We have to put some stopgaps in here.
And again, in a competitive system, people start thinking about, well, how can I get around that because it can be more competitive if I don't have to basically face the cost of this new regulation.
So they will hire lawyers and they will try to get around it.
And the more complex it becomes, the more complex the solution have to be.
And so this is also why lawyers actually make quite a bit of money to try to get around.
These rules, there was an entire team working on this and the chancellor himself presiding over the case we just discussed was kind of perplexed that you would have like a top investment bank and top lawyers basically creating something that is a scam.
It's not real.
It's just sort of to try to get around the regulations.
I'm saying this as a law professor, these are many of my former students who are doing this or students I will produce in the future, which of course creates also a bit of a dilemma for me because I'm part of a system that I'm criticizing.
Let me just be frank about that.
But they have the incentive structures in these firms to do this.
The point I would make is that in a highly complex system, in a system that is deeply regulated by law, especially finance is also deeply regulated, much of the competition today is not about something outside the law, it's the law itself.
It's basically using the law to get a head start over others by reducing regulatory cost by creating somewhat stronger attributes for capital.
So it's basically playing with the rules of the game rather than just playing the game.
That's what the system has become, to some extent it's unpreventable because all rules are necessarily incomplete, they're all somewhat open-ended subject to interpretation.
And if you start there and you carve out a niche for your own client to make a head start

over others and everybody else follows, you can imagine how many different and also interesting sometimes ingenious sort of devices you can create, but it makes it very hard for a regulator to regulate because of course regulation too is incomplete and regulations are always partial.
And if you can refashion something so that it looks a little different than what the regulator seemed to have regulated, you're getting out, you're wiggling out of the regulatory framework.
And then lastly, as you suggest, globalization means that, well, if necessary, I just shift my accounts from London to New York.
If New York has easier rules, I'm not going to stay in London or vice versa.
To the extent that I can pick and choose my rules by simply reincorporating elsewhere, shifting my accounts to a different jurisdiction, the less likely it is for any state to actually regulate effectively because it's always a partial regulation and there's always another option.
I want to just hold on this point because I think it's so important.
And I want to go back to the actual quote from the judge who presided over the Rascals case because I think it's extremely revealing.
So the quote from this judge is, quote, it is at least at first sight counterintuitive to think that one of the largest and most sophisticated investment banking institutions in the world, staffed by some of the foremost experts in the business and advised by the most eminent law firms, should have spent more than a decade solemnly entering into countless thousands of mutual transactions, which were either completely unnecessary, completely ineffective, or both.
The suspension of disbelief called for by the party's primary cases has not been easy.
Now first of all, I just think that is probably one of the best lines, paragraphs in a legal ruling ever, but I also think it's a perfect encapsulation of what's at stake here with what you're talking about, because in a capitalist system, this kind of thing isn't supposed to happen.
The entire social contract that underwrites capitalism, right, going back to Adam Smith and the Wealth of Nations, is that the pursuit of individual interests should produce some kind of social benefit, that by trying to make yourself richer, you will ultimately make everyone else richer.
And you know, we may have to tolerate some inequality here and there, but ultimately we'll all be better off.
And I think Rascals and sort of this process you're describing, because Rascals is not the only version of this, this is this kind of regulatory and legal arbitrage is happening all the time, it's completely undermines this social contract.
And even beyond just arbitrage, I mean, this is sort of something that we can, I think, apply to like everything we've been talking about here, right?
Shareholders using limited liability to squeeze as much profit out of a company as they can.
Just creating financial products that end up crashing the global economy.
Earlier you mentioned IP law, and we didn't get to talk about it as much, but there it's companies using patents to sort of destroy competition over things like DNA sequences that can hardly be considered innovations.
And in all of these cases, it's these actors pursuing their own interests at the expense

of everyone else.
And I think that just brings us to one of the most radical implications of your book, which is it really feels like we've built a legal structure in a way that we've seemingly broken or at least damaged the core mechanism by which capitalism is supposed to deliver for society.
I'm just wondering how you think about that, because that seems like a pretty profound change or implication at least.
So I agree with your analysis, basically what I always say, like you use a social resource, the legal system, it works only because most people actually believe in the authority of the law.
It's also a system that allows you to scale relations.
And the more you can use it in ways to create your own private wealth, the more of course also the interests are in using it exactly for this purpose and for not any other purpose for which it has been created.
I also agree that actually this has been turbocharged over time.
And I think the regulatory competition amongst countries, you know, opening basically your borders for capital flows and recognizing the laws from different jurisdictions has given those who hold capital and their lawyers really a menu of option to pick and choose the law by which they wish to be governed.
If everyone could just pick and choose the rules by which she wishes to be governed, we couldn't have anything like a social contract.
There wouldn't be a social contract.
We just pick and choose what we like best.
And then we make our money on that and forget what everybody else has or may not have.
And it's certainly true that it has become worse.
I would actually, however, argue that it has been at the very core of capitalism.
That is what capitalism is all about.
And you know, I think Adam Smith, when he talks about the invisible hand in his famous book, he has an entire section where he explains how the invisible hand works.
Why is it that merchants who venture abroad will still nonetheless share something with their fellow citizens at home?
Because inevitably, Smith's thought that the merchant will have to come home to repack, but also because at home he knows his institutions.
So he will always come home because that's where he knows the institutions, and I would say these are, of course, also the legal institutions.
And by coming home and sharing some of the goods and his experience, et cetera, he will share with his fellow citizens.
Now we have created through a host of different rules and regulations and choice of law rules a global system where nobody has to come back home.
You can stay in the Cayman Island and still actually you operate here in the US, that's why you make the money.
But legally, you might be in the Cayman Islands, or legally you might be in London.
So you pick and choose the laws that govern you, but without making a commitment really

to the people with whom you share everything else around you.
And of course, legal creatures are a separate story here as well.
So I think there is something that is innate to using the law in this way in capitalism.
And I think there have been periods when states have been able to cabin the excesses of capitalism for a while.
But when you look closer, even after major catastrophes, such as the Great Depression in the 1930s, World War II, and then the attempt after World War II to create a better global system and to stabilize domestic systems, again, through rules and regulations, it didn't take all that long to unravel the safeguards.
I mean, it starts already globally in the 50s and 60s to try to get around capital controls.
Once the US gets off the gold standard and capital controls are beginning to be removed, that's when things become wild again.
And we're seeing sort of the use of these mechanisms to create these competitive examples.
And then within two decades later, we are close to another major financial meltdown, which is prevented only by the central bank stepping in in a major way.
So there's, I think, an inherent dynamic here, which we have to come to terms with, and I think legal arbitrage is at the very core.
I don't think that like 400 years ago, people used it to the same extent.
But I think the basic idea was there.
Institutions like the trusts were born in the 12th century, the predecessor, to evade taxes.
This always been at the heart, was playing with the rules, getting away with something, and still pretending that actually what you do is legal.
It's eating the cake and having it too.
You can basically reallocate property rights from the commoners to the landlords without being accused of theft because you can say it's legal.
And so I think it's not that capitalism has been derailed and we can just go back to its safer core.
I think it's an inherent mechanism of capitalism itself.
I think that brings us, though, to what I've come to think about is quite possibly the core tension of your book and maybe one of the core tensions of capitalism itself, which is the way that this legal coding of capital is simultaneously a miracle and a curse.
Because if you're right, that this cuts to the core of capitalism, well, capitalism has provided a lot of social wealth, a lot of material progress, a very sharp rise in living standards.
And these coding mechanisms that we've talked about, these legal modules that we've talked about have been really important to that, right?
Property rights, one of the few things economists agree on is that property rights are central to economic growth.
Limited liability, it incentivizes entrepreneurship, patents helps for innovation.
These debt instruments, at least in theory, expand access to credit that allows businesses to make more productive investments in the economy, that expands credit to people so that they can afford houses.

And so I think there's an argument to be made that maybe we're being too negative on the system, that so many of the fruits of modernity, so much of the wealth that we've gained in the past few hundred years, can at least be in part attributed to the ways we've used law to turn these ordinary assets into wealth-generating capital, that it's this miracle of our modern world that we've been able to create legal fictions that then allow us to generate wealth in this way.
And so I'm wondering how you wrestle with this tension, because on the other hand, I think you're right.
I think at least, at the very least now, and to me, it does feel like there has been a wealth, because these mechanisms clearly helped enable a lot of wealth generation and creation in previous eras, and now it really does feel like they're being used as tools of extraction, that they're contributing more and more often to financial crisis, that they're leading to these unprecedented levels of inequality.
And so I'm just wondering how you navigate and grapple with that tension, that on the one hand, these legal devices can be considered miracles, and on the other hand, they could be considered these really pernicious, extractive mechanisms that have harmed our system and a lot of people in it.
Yeah.
No, I think there is this tension, and I also have to say, I do believe in the law.
I also believe in the ability to engage in relatively decentralized exchange transactions.
So if there's one message I want to really get across, and I think you just mentioned it, if it is the law, if it is the social resource that creates all these wealth, maybe we can also find a better way of doing this.
If it's not just the skills of the most sophisticated people and we can't compete with them, they're just outcompeting us, that's one thing.
If we're saying, actually, guys, what you're doing is you're using something that belongs to us, and that we could also reconfigure in different ways, then we might be producing also social goods in different types of ways, and maybe not by giving them some, the opportunity to skim off the cream as we're creating these social goods.
So let's go back to housing.
In the late 1960s, the United States decided that the housing crisis will be solved by giving everybody access to credit in a private credit system.
That's a decision to be made.
There might be other ways in which we can create housing.
There are also other ways in which we can govern the credit system.
So each of the choices that we make, I think we have to be much more conscious about the extent to which we're using a social resource for some to then actually get an extra top-off like with banking.
In theory today, with new crypto technologies, you could cut out the middleman, the banks you could give all people like a wallet at the central bank and have a safe payment system.
You can still discuss how to allocate credit, but we could have a safe payment system.
Nobody's going there because the idea that the banks are central to our payment system is so deeply ingrained in the thinking also of the central bank, I said we won't make

these kinds of choices.
What I'm trying to say is actually we have many more choices and also I think looking back is there have always been a lot of losers on the way.
Yes, if you look at global statistics and history, et cetera, only with the takeoff of capitalism have countries become really wealthy also at a national level.
That's not only about private wealth, it's also about national wealth, but we can also see that's part of Piketty's work and in his team's work is that within these countries wealth gaps always increase within capitalism as well.
Now, if the law is a social resource, could we basically reduce the cost for the losers?
Could we make this a more equitable system?
I don't want to say necessarily the answer is no, I think my hope is still that we could.
I would also add to that we must because climate change might be really the binding constraint that we are facing in terms of living with a system that is always expanding, always trying to shift risks to others.
We might be able to get away with this a lot within social system, but nature doesn't care about our ideas, nature is just reacting in its own way and not in a good way these days.
I think that's a good place to talk about what possible solutions may exist.
We spoke earlier about the difficulty of regulation, of sort of taming this very decentralized legal system, but are there solutions that you can imagine that you think can be employed that would maybe retain some of the parts of the system that have brought so much wealth and prosperity and helped us scale society in this way while also trying to weed out or at least reduce the power of some of these more negative elements?
Are there solutions out there that you think are satisfactory and are there any states trying them?
So there are probably lots of different solutions and I think many states are trying to use typically regulatory law, minister of law, some kind of caps to cabin the system and sometimes also quite successfully, I would say.
I think some of the consumer protection law in the EU or labor protection is probably more advanced than what we have in this country, but my goal in my own work is really to do this again internally to the capitalist system, to try to understand the logic of the system and maybe to recode it in a much more fundamental way.
So not only to create new constraints outside because my prediction is that we'll wiggle around this again, but sort of to rethink the predistribution, the creation of wealth, the use of law to create capital from the outset.
So I'm trying to develop some really basic principles, each of which would have to be translated into institutional realization and that it's a hard work that I haven't completed myself yet, but I just want to share with you the direction of my thinking.
So it starts with a basic premise that all power should be accountable, all power, not only public power, also private power, and to the extent that these legal modules are being used to create private power, we have to think about how to hold private power accountable.
Most people turn to the market to do the accountability, but the market typically plays to some of these
constituencies not to others and very often uses rather blunt mechanisms like withholding

capital altogether from either states or entities, which harms the workers, but not necessarily maybe the management or the government that has done the mismanagement.
So we have to think about accountability mechanisms for private parties.
We typically rely on the fact that while they have property right, they got consent through contracts.
So it's ex ante control, so we don't need exposed accountability.
But I think in political systems, we don't vote only once and say forever, they cannot allow real power over us, but we vote repeatedly and we have other mechanisms of control as well.
So we need more checks and balances in the economy.
So that's just one.
The other one is I would simply say there shouldn't be any rights without obligations.
So if you insist on limited liability and on plowing all the profits back and not being responsible for the company that goes under your hands, and I'm talking about the investors now, of course, then this might have an impact on how we treat you and your rights as a shareholder to begin with.
So this would be another one, no rights without responsibility, just to recap, so we're saying no power without accountability, no rights without responsibilities, and then I would add to that only humans are rights holders.
We have conferred many of the individual rights that some say would come from natural law, I do not believe in that, but the individual rights, human rights, we have used many of these mechanisms, several corporations are rights holders too.
I still would say corporations can own assets, but they should not necessarily get the same kind of constitutional protection for ownership that individuals do, or only their shareholders behind that in a prerata fashion, which would change the argument quite radically.
I don't see why a Supreme Court in this country can argue that corporations shall have religious right or freedom of speech.
They can't speak, they're legal creatures, they're non-entities, they act only through humans and on behalf of the humans in the end, and I think we should be more clear on that.
And then last but not least, I would say, and you will not have access to the coercive means that the state has an offer unless you abide by principles one through three.
So the logic is basically, actually, I have nothing against markets, I have nothing against change, I have nothing against making autonomous decision, I do not want to have central planning, but I think if we want to be true to some of these mechanisms, if we want to go back to the logic that Adam Smith associated with markets, that's a very, very different market from the kind of monster we have created over the last couple of centuries.
I think that's such a powerful framework.
And I'm interested in trying one other idea on you because one thing I began wondering while reading your book is that if really any asset, real or imagined, can be coded as capital, then what would it mean to use that power to make the world better?
You mentioned the climate crisis earlier and the idea that kept coming to my head about this was from Kim Stanley Robinson's book, The Ministry for the Future, which takes place

sort of in the near future as societies come to grips with climate change.
And one of the things that central banks come up with in that future is these things called carbon coins, which are basically currencies that are used to pay companies and individuals and countries for emissions reductions.
And reading your book, I started wondering if maybe that isn't as wild of an idea as it sounds when you first hear it, right?
How capital is, is the promise of future returns coded in law?
So it doesn't seem so crazy to me that if we wanted to, we could use these same techniques we've been talking about in this conversation to transform a different kind of future returns, right?
The returns generated by a healthy climate into law.
So I'm wondering what you think of that idea and then more broadly about this possibility of trying to use the coding techniques that have in so many ways been used for sort of the powerful and in ways that sort of degrade our system and take those techniques and use them in ways that could actually make the world better.
No, I think, you know, this is, this is my hope as well.
I mean, why, why am I writing books like this?
Because I think I want to do a diagnosis that we can turn into something different as well.
So if it is, and I'm convinced that it is, if it is the social resource that the hands of some becomes something that is highly monetizable and profitable, we could also do other things with it.
If there's a little bit of salt I want to throw into this, this will not be as profitable for some as the past has been.
And I don't think it should be.
But I think that's also the power struggle that we have to go through because, you know, some will claim that, and they will claim this as theirs, they've had their property rights including the corporations, they have entrenched interest in the system operating the way it is and delivering the returns that they want.
And I think any kind of recoding will take away a little bit of the punch ball for making the amounts of money that are being made.
There are still returns, we want to have a competitive system, but we also want to have other values being vindicated with the social resource and survival of most people and humane conditions on this planet seems to be a worthwhile task.
But it's not something that you can easily monetize.
So we want to direct our social resource to something which I believe is an urgent task, but we have to think very hard how to do this and also how to reconfigure some of the legal institutions that we have to make this possible.
We talked a lot about limited liability, right?
So it was a great invention to broaden the capital base.
Now, we have enough capital flushing around today.
We don't need limited liability maybe to get even more, but we do have an issue with investing in brown assets.
Brown assets are basically assets of companies, shares, bonds or their financial assets in

companies that pollute.
And there are a number of investors out there who don't believe the transition is coming and that it's enormously profitable to invest in brown assets.
And that would also argue that it's actually very difficult to price the future risk of brown assets.
And I would basically argue we can make it easier for them to price the risk of brown assets by taking away limited liability.
If you consciously and intentionally invest in something that we know is destroying the living conditions for humans, then the planet will survive without us.
That's not the issue.
It's questions whether we will survive on this planet.
If you knowingly destroy the conditions for us to survive on this planet in order to make short-term profit, I'm not sure why we should give you a limited liability.
And if investors realize that, might also find the skills to ensure that they price in the cost of the losses that they will have to take themselves as well in the future.
So I think there are a number of institutions where we said this really has to go if we want to be serious about this and then the questions how to fight the political struggle to get there.
I just have one last question before we get to books.
Because you mentioned earlier that it's a lot of your students who are the ones who end up engaging in the kind of problematic legal manipulation that we've been discussing here.
But it also seems like it's those same students who are going to be needed to implement the kind of solutions we've been discussing to push the system in the right direction, especially considering how decentralized the law is.
So what is it that you say to these students and to law students more broadly, who are about to graduate and be faced with this huge amount of responsibility and how they use their talents?
For me, of course, I'm honest with my students, I tell them what I think.
I also realize the bind that they are in.
And I said before, I'm also part of the system.
So they're paying a lot of fees to come to Columbia Law School.
It's another sort of part of a capital system where we think, yes, of course, people who make a lot of money in the future can also pay high fees for their legal education.
And so they do.
But when they graduate from institutions such as Columbia or Harvard or anywhere you name it, they come out with a lot of debt.
And the easiest way for them to reduce their debt is to code capital, the big Wall Street firm.
So it's kind of a cycle.
I mean, what I'm trying to tell the students is exactly what you said before.
This is a phenomenal social resource, and there are lots of different things we can do with it.

And it started at least as long as we're together at the law school, the process to think about alternatives.
Typically, law is being taught mostly looking backwards, telling the students how the courts have decided our legislation exists already, less so how to imagine a different future.
They learn this in part when they practice law, but then they learn it in a particular way, how to make the most money for their clients, basically.
And I would like to harness that potential and say, can we imagine how to use this enormous intellectual potential to do things differently?
And I think it is there.
And I do find also the aspiration amongst the students, I think this generation knows very well that there are living in volatile times, that their future is very uncertain.
And they think very hard about where they want to go.
Their entire law students organizations that have blacklisted law firms that are only defending brown asset issuers, and we're just not going to go there.
So you see from the student body itself a search for alternatives.
And I think that gives me ammunition to say, let's just do this together.
I think that's a great place to end.
And I hope many of those students are listening to you.
So let's go to the question we always end the Ezra Klein Show on, which is, what are three books that have influenced you that you would recommend to the audience?
So of course, I have to mention Piketty's Capital in the 21st Century.
Many of the data that he provided there were for me ammunition to think about the legal structures that Mindhack actually can help explain the data underneath.
So that would be one.
I would also in terms, especially the financial crisis that we talked about a lot at Woodname Adam Tuz's Crash, which I think is a great book that also goes into some length into the legal structures of CDOs and CDSs.
But it's of course written by a global historian who really sees, campaigned the big brushes of sort of the interdependencies of the financial system and the institutions.
And then a book that came out after I wrote my book, but won by an author who I quote in the book at the very beginning when I define capitalist as Jonathan Levy.
And he published a book, I think it was last year, Ages of American Capitalism, where he goes through this history of American Capitalism and combines institutional, legal, and cultural and economic history in a way that I found enormously inspiring.
Katerina Fistore, thank you so much for being here.
Your book is The Code of Capital.
It was great chatting with you.
Thank you so much for having me.
I really enjoyed our conversation.
Thank you so much to Katerina for being here and to you all for tuning in, especially to such a dense episode.
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