

TAXING CONTRACTUAL COMPLEXITY

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ABSTRACT

Consumers rarely understand contracts offered by sellers. It does not make sense for consumers to invest in understanding these contracts because they are typically complex, time and attention are limited, and the value at stake is often low. Because consumers don't understand contracts and information sharing among consumers is costly, sellers can profit by drafting contracts that harm consumers more than they benefit sellers. Sellers who would like to offer efficient contracts face competitive pressures not to do so because consumers who do not understand contracts cannot appreciate the benefits. Ideally, contracts would be simpler and easier to understand, but regulators don't know the optimal complexity for each contract. Sellers know the value of the contract, but do not internalize the costs of complexity. To the contrary, sellers can benefit from making contracts more complex than necessary to obscure anti-consumer terms.

This article proposes a new solution to this famous problem: a tax that

sellers would pay to present a contract to consumers, coupled with a subsidy to consumers who comprehend contracts and share information. The tax would be proportionate to the cost consumers would incur if they invested in comprehending the contract. It would be assessed whenever sellers presented a contract, regardless of whether or not consumers signed. We show that this tax and subsidy solution would cause sellers to make their contracts simpler to reduce their own tax burdens. Thus, sellers would internalize the comprehension costs that they can currently impose on consumers. We demonstrate that sellers can be compelled to forego strategic obfuscation if this tax is paired with a subsidy to encourage consumer comprehension and information sharing. This tax and subsidy pairing would penalize inefficient contracts while minimizing the burden on efficient contracts. Inefficient contracts would thereby become financially unsustainable.

I. INTRODUCTION

Consumer attention is a scarce common resource.¹ It is *scarce* because our cognitive ability to process information is limited. When we pay attention to one thing, we inevitably deflect attention from other things.² Consumer attention is also a *common* resource because it benefits not only the particular consumer who pays attention, but also *other* consumers. For example, when a consumer pays attention to a company's "terms and conditions," that consumer can alert others about consumer-unfriendly terms through social media channels. In fact, even without communication between consumers, sellers may make their form contracts more friendly to consumers if enough consumers comprehend them.³

Firms generate negative externalities by over-exploiting consumers' limited attention through long and complex standardized agreements, even for transactions that are trivial in value.⁴ The use of these overly complex

¹ See Michael Simkovic & Meirav Furth-Matzkin, *Proportional Contracts*, 107 IOWA L. REV. 229 (2021).

² See, e.g., Lisbet Berg & Åse Gornitzka, *The Consumer Attention Deficit Syndrome: Consumer Choices in Complex Markets*, 55 ACTA SOCIOLOGICA 159, 160 (2012); SENDHIL MULLAINATHAN & ELДАР SHAFIR, SCARCITY: WHY HAVING TOO LITTLE MEANS SO MUCH (2013).

³ This is because sellers realize they might lose business as a result of using one-sided contracts, in particular the business of the consumers who read and understand the contract. Comprehending consumers can protect non-comprehending consumers, at least in part, when sellers use a uniform form contract for all consumers. Sellers might do so because it is too costly or impracticable to distinguish between comprehending and non-comprehending consumers and to develop separate contracts for each consumer type.

⁴ See Simkovic & Furth-Matzkin, *supra* note 1.

contracts prevents most consumers from reading and understanding the terms of their agreements.⁵

If more consumers could comprehend contractual terms, then more consumers could shop around for better terms, negotiate, or decline to transact with a seller who failed to offer sufficiently buyer-friendly terms.⁶ In this hypothetical world of widespread comprehension, sellers would be encouraged to offer *all* consumers more buyer-friendly terms.⁷ This means that comprehending consumers could generate *positive* externalities, improving the terms for non-reading consumers.⁸

This Article develops an illustrative model which shows that sellers may be incentivized to make it exceedingly difficult for even a small fraction of consumers to comprehend their contracts.⁹ As has been previously observed, even small search costs can decimate competition on contract terms by discouraging consumers from reading.¹⁰ Furthermore, sellers have incentives to encourage consumers to harbor overly optimistic views about their contracts by selectively highlighting benefits and obscuring costs.¹¹

Indeed, empirical evidence shows that sellers increasingly make their

⁵ Indeed, previous empirical studies indicate that consumers often fail to read standardized agreements. *See, e.g.*, Yannis Bakos, Florencia Marotta-Wurgler & David R. Trossen, *Does Anyone Read the Fine Print? Consumer Attention to Standard-Form Contracts*, 43 J. LEGAL STUD. 1 (2014) (showing that most online software buyers fail to access the "terms and conditions" webpage before making the purchase); Uri Benoliel & Shmuel I. Becher, *The Duty to Read the Unreadable*, 60 B.C. L. REV. 2255 (2019) (finding, based on a survey of 500 U.S. websites, that more than 99% of the websites' "terms and conditions" are unreadable by lay consumers).

⁶ *See, e.g.*, Ian Ayres & Alan Schwartz, *The No-Reading Problem in Consumer Contract Law*, 66 STAN. L. REV. 545 (2014).

⁷ To the extent that sellers can distinguish between readers and non-readers, they may offer readers better terms. This would prevent readers from improving terms for non-readers. However, sellers often cannot perfectly distinguish between readers and non-readers. Therefore, a large group of readers would likely generate positive externalities that benefit others.

⁸ *See, e.g.*, Alan Schwartz & Louis Wilde, *Intervening In Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630 (1979).

⁹ For a related model of seller incentives to obfuscate information from consumers and to increase search costs, *see* Glenn Ellison & Alexander Wolitzky, *A Search Cost Model of Obfuscation*, 43 RAND J. ECON. 417 (2012) (arguing that oligopolistic firms have incentives to increase consumer search costs and thereby reduce competition and increase price; "even transparent firms benefit from serving an obfuscation-rich market, as their customers are prevented from comparison-shopping by other firms' obfuscation.").

¹⁰ *See, e.g.*, Avery Katz, *Your Terms or Mine? The Duty to Read the Fine Print in Contracts*, 21 RAND J. ECON. 518, 527 (1990).

¹¹ Ayres & Schwartz, *supra* note 6; *see also* Oren Bar-Gill & Omri Ben-Shahar, *Manipulation by Mislaid Priorities* (Apr. 2021) (unpublished manuscript) (on file with author).

contracts so long and complicated that most consumers do not read them,¹² at least not until it is too late.¹³ In a world in which consumers cannot distinguish between sellers with varying contract quality, sellers have incentives to use ever more pro-seller terms because they can do so without penalty.¹⁴ These terms can be inefficient if they hurt consumers more than they help sellers. If consumers do not comprehend the contract, then consumers cannot provide feedback to sellers or refuse to transact because of inefficient contract terms. Sellers consequently lack both the incentive and the information needed to consider the negative effects that their contract terms have on consumers.¹⁵

¹² See, e.g., Bakos et al., *supra* note 5 (finding that only one out of 100,000 online software buyers accesses the “terms and conditions” webpage); see also Robert Hillman, *Online Boilerplate: Would Mandatory Website Disclosure of E-Standard Terms Backfire?* 104 MICH. L. REV. 837 (2006) (finding that only four percent of those who purchased products online claim to read standard-form contracts); Shmuel Becher & Esther Unger-Aviram, *The Law of Standard Form Contracts: Misguided Intuitions and Suggestions for Reconstruction*, 8 DEPAUL BUS. & COM. L.J. 199 (2010) (finding that sixty percent of the survey respondents reportedly only skim or reads parts of their standardized contracts before entering the transaction); Victoria Plaut & Robert Bartlett, *Blind Consent? A Social Psychological Investigation of the Non-Readership of Click-Through Agreements*, 36 L. & HUM. BEHAV. 293 (2012) (finding that about eighty percent of the survey participants reportedly do not read standardized contracts).

¹³ Meirav Furth-Matzkin & Roseanna Sommers, *Consumer Psychology and the Problem of Fine-Print Fraud*, 72 STAN. L. REV. 503 (2020) (finding that consumers cannot tell which terms are legally void and fail to take action after they have been defrauded); Meirav Furth-Matzkin, *On the Unexpected Use of Unenforceable Contract Terms: Evidence from the Residential Rental Market*, 9 J. LEGAL ANALYSIS 1 (2017) (finding that most tenants who read leases do so only after entering them, when a problem arises); see also Meirav Furth-Matzkin, *The Harmful Effects of Unenforceable Contract Terms: Experimental Evidence*, 70 ALA. L. REV. 1031 (2019); Tess Wilkinson-Ryan, *The Perverse Consequences of Disclosing Standard Terms*, 103 CORNELL L. REV. 117 (2017).

¹⁴ Indeed, sellers may be forced to do so to compete successfully on price. See OREN BARGILL, *SEDUCTION BY CONTRACT: LAW, ECONOMICS, AND PSYCHOLOGY IN CONSUMER MARKETS* 13-16 (2012).

¹⁵ A seller:

is indifferent between the default-rule-tracking contract and an inefficient contract when:

$$s - \rho(s + PS) = 0$$

and prefers the inefficient contract when:

$$s - \rho(s + PS) > 0$$

If regulators had perfect information, they could simply ban inefficient contract terms that harm consumers more than they benefit sellers.¹⁶ But regulators usually cannot readily observe either the benefits of a contract term to sellers or the costs to consumers.¹⁷

The ideal way to determine whether a term is socially desirable is to make that term available in a market where consumers understand all contract terms. In such a market, consumers would incorporate the implications of the contract terms into their purchasing decisions and only enter contracts that make them better off. Informed consumer purchasing decisions would, in turn, provide feedback to sellers, who would be forced to improve their contracts to survive in a competitive market.¹⁸

However, this ideal is *costly* because of the attention costs inherent in numerous individual consumers understanding contract terms and forming independent judgments about them.¹⁹ When such costs are not taken into

Where:

s : net benefit to the seller (benefits to seller minus costs to seller) per transaction, excluding drafting costs

x : net cost to each consumer (costs to buyer minus benefits to buyer), excluding comprehension costs

ρ : the percentage of consumers who comprehend a contract.
($0 \leq \rho \leq 1$)

PS : Producer (seller) Surplus without a contract

x : net cost to each consumer (costs to buyer minus benefits to buyer), excluding comprehension costs

A contract is efficient, ignoring comprehension and drafting costs, when $s - x > 0$.

And comprehending consumers will only enter an efficient contract, but non-comprehending consumers will enter an inefficient contract.

¹⁶ Indeed, regulators and courts do ban certain extreme terms that are presumed to be inefficient because no consumer who understood them could presumably agree to them. *See, e.g., Furth-Matzkin, supra* note 13.

¹⁷ *See, e.g., Eyal Zamir & Ian Ayres, A Theory of Mandatory Rules: Typology, Policy, and Design*, 99 TEX. L. REV. 284 (2020).

¹⁸ *Id.*

¹⁹ *See, e.g., Richard Craswell, Taking Information Seriously: Misrepresentation and Nondisclosure in Contract Law and Elsewhere*, 92 VA. L. REV. 565, 591 (2006).

account—as they are not under the current legal regime²⁰—sellers do not fully internalize either the costs to consumers of anti-consumer contracts or the costs to consumers of reading and understanding contracts. This leads to an overproduction of lengthy and complicated contracts that are also typically pro-seller.²¹

Our Article proposes to solve this problem by changing both sellers' incentives regarding contract drafting and consumers' incentives regarding contract comprehension. In particular, we propose to force sellers to internalize contract comprehension costs through quasi-Pigouvian taxation of sellers' contracts,²² while also subsidizing consumer comprehension and information sharing.

This tax-subsidy pairing is superior to a tax alone because the pairing minimizes burdens on efficient contracts, while penalizing inefficient contracts. Critically, the tax would be imposed upon the presentation of a contract, regardless of whether or not the consumer chooses to transact. Moreover, the tax-subsidy pairing impedes strategic obfuscation by sellers with inefficient contracts who, even after paying a tax, could still profit from making those contracts incomprehensible. The subsidy rewards comprehending consumers for the positive externalities they generate and encourages higher consumer comprehension levels, even when the contract is difficult to comprehend.²³ The pairing is also superior to a subsidy alone because the tax prevents excessive production of overly-complex contracts.²⁴

²⁰ Consumer attention is effectively treated as unlimited under the “Duty to Read” doctrine because consumers are bound to contracts they sign regardless of length, complexity, value of the underlying transaction to the consumer, or consumer comprehension. This has resulted in consumers encountering more contracts—and more complicated contracts—than it could possibly make sense for them to read and understand. *See, e.g.*, Simkovic & Furth-Matzkin, *supra* note 1 at 2-14; Russell Korobkin, *The Borat Problem in Negotiation: Fraud, Assent, and the Behavioral Law and Economics of Standard Form Contracts*, 101 CAL. L. REV. 51, 52 (2013).

²¹ *See, e.g.*, Ayres & Schwartz, *supra* note 6.

²² *See generally* A. C. PIGOU, *THE ECONOMICS OF WELFARE* (1920); William Baumol, *On Taxation and the Control of Externalities*, 62 AM. ECON. REV. 307 (1972); *see also* Jonathan S. Masur & Eric A. Posner, *Toward a Pigouvian State*, 164 U. PA. L. REV. 93 (2015); Steven Shavell, *Corrective Taxation Versus Liability as a Solution to the Problem of Harmful Externalities*, 54 J.L. & ECON. S249 (2011) (“The corrective tax has long been viewed by most economists as . . . the theoretically preferred remedy for the problem of harmful externalities”); N. Gregory Mankiw, *Smart Taxes: An Open Invitation to Join the Pigou Club*, 35 E. ECON. J. 14, 15 (2009); CASS R. SUNSTEIN, *RISK AND REASON* 270-71 (2002).

²³ *See infra* section II. Pigouvian Contracts.

²⁴ Using “carrots” (i.e., subsidies) can create perverse incentives. *See, e.g.*, Brian Galle, *The Tragedy of the Carrots: Economics and Politics in the Choice of Price Instruments*, 64 STAN.

We demonstrate that our proposed tax would fall more heavily on sellers using inefficient contracts than on those using efficient contracts, *even though* regulators may not know ex-ante which contracts are efficient.

We also argue that our ex-ante approach is superior to an ex-post approach that relies on consumer complaints and lawsuits. This is because consumers have no legal recourse once they consent to most contract terms, except when the terms are legally void and unenforceable. However, even when terms are unenforceable, consumers rarely pursue remedies because they mistakenly believe that the terms are binding.²⁵ Moreover, the widespread use of binding arbitration effectively strips consumers of a collective remedy that could make it economically feasible for them to obtain redress with the aid of counsel.²⁶ In addition, ex-post remedies face challenging evidentiary issues, because parties to litigation may misrepresent their prior knowledge, intent, and actions. In addition, ex-post remedies can introduce inconsistency, non-uniformity, and unpredictability in the application of the law.

This Article proceeds as follows. In Part II, we explain the problem of consumer non-comprehension and resulting inefficiencies in contract terms. We assume that: (1) inefficient contracts will only be entered into by non-comprehending consumers; (2) that consumer comprehension falls as contracts become costlier to comprehend; and (3) that sellers control how costly contracts are to comprehend. This helps explain the widely documented empirical findings that contracts have become longer and more pro-seller over time, and that consumer readership is often negligible.²⁷ We demonstrate that our proposed tax would improve efficiency by changing sellers' incentives, and that subsidizing consumer comprehension efforts

L. REV. 797, 824 (2012). However, below we argue that these perverse incentives may be unlikely to generate waste, such as excessive reading of contracts by uninterested consumers, given the limits of consumer time and attention, and the fact that consumers will still have incentives to read the contracts that are of greatest value to them.

²⁵ See supra note 13.

²⁶ Sarath Sanga, A New Strategy for Regulating Arbitration, 113 NW. U. L. REV. 1121, 1152 (2019); Judith Resnik, Diffusing Disputes: The Public in the Private of Arbitration, the Private in Courts, and the Erasure of Rights, 124 YALE L.J. 2804, 2870–72 (2015); Talia Fisher, Law and Economics of Alternative Dispute Resolution, in THE OXFORD HANDBOOK OF LAW AND ECONOMICS 280, 283 (Francesco Parisi ed., 2017).

²⁷ See, e.g., Bakos et al., supra note 5; Florencia Marotta-Wurgler, Will Increased Disclosure Help? Evaluating the Recommendations of the ALI's "Principles of the Law of Software Contracts", 78 U. CHI. L. REV. 165, 179-81 (2011); Aleecia M. McDonald & Lorrie Faith Cranor, The Cost of Reading Privacy Policies, 4 I/S: J.L. & POL'Y INFO. SOC'Y 543, 563-64 (2008); Richard A. Epstein, Contract, Not Regulation: UCITA and High-Tech Consumers Meet Their Consumer Protection Critics, in CONSUMER PROTECTION IN THE AGE OF THE "INFORMATION ECONOMY" 205, 227 (Jane K. Winn ed., 2006); Katz, supra note 10.

further increases efficiency, even if sellers capture the subsidy. Part III addresses details of how the tax would be administered, including potential enforcement and constitutional challenges. Part IV addresses the remaining potential concerns and objections to our proposal. Part V concludes.

II. PIGOUVIAN CONTRACTS

Under the current regime, sellers have incentives to draft overly long and complicated contracts that are inefficiently pro-seller.²⁸ Complicated contracts reduce consumer comprehension. Consumers who do not comprehend contracts cannot selectively reject the inefficient ones. This enables sellers to unilaterally benefit while reducing social welfare.

The economies of scale sellers face—contrasted with individual decision-making by consumers—enable sellers to develop a contract complicated enough that few if any consumers will read it. Theoretically, consumers or third parties may be able to reduce information costs by generating reviews or summaries. However, high-quality, reliable and unbiased reviews may be under-produced because the mechanism for consumers to compensate each other and to exclude free-riders from using this information are of limited effectiveness.²⁹ In practice, the most salient reviews (for example, Consumer Reports or Yelp) tend to focus on the underlying product or service rather than on contract terms.

Even when contract reviews or summaries are available, it is costly for individual consumers to determine which reviews are high quality and reliable. Many of the reviews may be biased because they are generated by or paid for by a seller or its competitors.³⁰ This can also reduce the reliability

²⁸ A contract is inefficient if it harms consumers more than it benefits sellers. The harms and benefits of a contract can be understood in comparison to the baseline of no contract—the deal that would be struck under default rules—or in comparison to a simpler contract with fewer terms.

²⁹ This is one example of the well-known problem of undersupply of activities that generate positive externalities. See Paul A. Samuelson, *Diagrammatic Exposition of a Theory of Public Expenditure*, 37 REV. ECON. & STAT. 350 (1955); Joseph E. Stiglitz, *The Contributions of the Economics of Information to Twentieth Century Economics*, 115 Q. J. ECON. 1441, 1448 (2000) (“information [is similar to] a public good—its consumption is nonrivalrous, and so, even if it is possible to exclude others from enjoying the benefits of some piece of knowledge, it is socially inefficient to do so; and it is often difficult to exclude individuals from enjoying the benefits.”).

³⁰ Yonathan Arbel, *Reputation Failure: The Limits of Market Discipline in Consumer Markets*, 54 WAKE FOREST L. REV. 1239, 1261 (2019) (discussing the practice of “shilling,” “fake reviews” or “astroturfing,” involving “the provision of payments in exchange for (unfounded) positive reviews.”).

of quantitative aggregations of reviews based on numeric scores.³¹

Sellers may wish to explain the desirable or attractive aspects of their contracts to consumers, while hiding the aspects that will be unattractive to consumers.³² Similarly, sellers have little reason to point out problems with competitors' contracts because other sellers can retaliate. Moreover, sellers are unlikely to benefit from criticizing competitors' contracts because consumers may choose a *third* seller's product or service or decline to transact.

Neither sellers nor comprehending consumers have incentives to sufficiently educate non-comprehending consumers about sellers' form contracts. Therefore, consistent with the empirical literature, most consumers do not fully comprehend contracts they encounter. This is troubling because low comprehension increases sellers' returns from using inefficient contract terms and causes such terms to proliferate.

It is not feasible to directly tax sellers for the costs imposed by inefficient contracts because regulators do not have enough information about seller and consumer preferences to know the full costs and benefits of contracts. Without this information, regulators also do not know the optimal complexity for a particular contract. Because of this information limitation, we propose that regulators only tax sellers for comprehension costs, which are easier to observe.

Sellers would be taxed when they presented a contract to consumers, whether or not the consumer assented to the contract. The tax would be proportional to the cost consumers would incur if they invested enough resources to understand the contract. This tax would encourage sellers to simplify their contracts to reduce the tax. Simpler contracts would be easier for consumers to comprehend. As more consumers comprehend contracts, they will reject inefficient contracts. When a consumer rejects the inefficient contract, the sellers must still pay the tax, but does not benefit from making a sale. Thus, per-sale, the tax falls more heavily on inefficient contracts.

We also advocate subsidizing consumer comprehension and information sharing. Subsidization has two benefits.

First, subsidization would prevent sellers from intentionally driving up comprehension costs to drive down consumer comprehension. Without a subsidy to consumers, a seller might decide that the benefits of a contract to the seller were so great, even though the costs to consumers were even

³¹ *Id.*

³² *See, e.g.,* Bar-Gill & Ben-Sahar, *supra* note 6; Ayres & Schwartz, *supra* note 6.

greater, that it would be advantageous to deter consumers from comprehending by increasing complexity. The seller would pay a high tax, but could still profit by acquiring consumers who did not understand the contract. The subsidy defeats this obfuscation strategy. As the contract became more complex, the subsidy payment to consumers would get larger. Thus, consumers would have more incentives, and more resources, to understand the contract and would not be easily deterred. Consumers could even use the subsidy to hire someone to assist them in understanding the contract. Once consumers understood that the contract would harm them, they would decline to transact. The seller could not compensate consumers enough to induce them to sign, because the inefficient contract harms consumers more than it benefits sellers.

Second, subsidization would reduce the burden on sellers using efficient contracts. Once consumers understand a contract, they will transact if it is efficient and decline if it is inefficient. Therefore, sellers using efficient contracts can capture a portion of the subsidy and offset the tax by increasing their prices. Sellers using inefficient contracts cannot recoup the tax, because comprehending consumers would decline to transact with them.

Our approach realigns sellers' drafting incentives and consumers' comprehension incentives with the theory underlying contract law: that the parties will only enter into a transaction that they reasonably expect to be mutually beneficial. Under this regime, sellers will draft simpler contracts and consumers will comprehend those contracts. Collective action problems that prevent consumers from sharing information will be mitigated. Most importantly, with high levels of consumer comprehension, more consumers will provide feedback to sellers—either through refusing to transact or complaining—and sellers will then improve their contracts.

The system we propose would have costs as well as benefits.

The main benefit of our proposal is that the tax would lead sellers to invest in improving and simplifying contracts. Because consumers would understand the benefits of these improved contracts, sellers could obtain higher prices or attract more business. Sellers using inefficient contracts that harm consumers would lose business and would be gradually driven out of the market.

In a world with Pigouvian taxation, sellers would improve their contracts.³³ Valuable provisions will survive, while inefficient or overly

³³ Simkovic & Furth-Matzkin, *supra* note 1, at 234-236.

complex provisions, like an extended warranty for an inexpensive item, will collapse under the weight of the high associated taxes.³⁴ For some low-value transactions, sellers might not use a contract at all, as is frequently the case today.³⁵

Sellers might also shift from contractual to technological solutions. For example, sellers could make it difficult to use their product or service in a manner that is currently prohibited by contract.³⁶ This shift could achieve sellers' goals while using less consumer attention.

Some consumers would spend time and resources comprehending contracts. But they would be compensated through a subsidy and would also benefit from better contracts. Other consumers could benefit from higher contract quality without investing in comprehension themselves. But these consumers would not be free riders: by paying a higher price and forgoing the subsidy, they would compensate sellers and comprehending consumers for jointly improving contract quality.

The government might bear some of the costs of evaluating contracts, collecting the tax, and disbursing the subsidy. But governments would benefit from a self-improving, self-policing market for contracts.

Our proposal would force sellers to internalize a negative externality—the cost to consumers of comprehending contracts—and to compensate reading consumers for producing a public good—contract evaluation that benefits all consumers. If administrative costs are not excessive, our proposal's benefits would exceed the costs.

III. TAX ADMINISTRATION & INSTITUTIONAL DESIGN

We propose that sellers be made to internalize the comprehension costs they impose on consumers through complex contracts. Toward that end, sellers would pay a quasi-Pigouvian tax each time they present a contract to consumers.³⁷ The tax would be set equal to the value of consumer and lawyer

³⁴ Such warranties on inexpensive items are notoriously overpriced. CHRISTIAN TWIGG-FLESNER, CONSUMER PRODUCT GUARANTEES 99 (2017); Korobkin, *supra* note 20, at 1233; Zhiqi Chen & Thomas W. Ross, *Why are Extended Warranties so Expensive?*, 45 ECON. LETTERS 253 (1994).

³⁵ For example, restaurants and grocery stores do not typically use contracts when transacting with consumers.

³⁶ For example, technical solutions can make it difficult to copy and paste or scrape text from a website. LAWRENCE LESSIG, CODE AND OTHER LAWS OF CYBERSPACE 57 (1999).

³⁷ For an explanation of Pigouvian taxation, see *supra* note 22.

time required to understand the contract.³⁸

A. Setting the Tax

We propose a method that regulators could use to estimate the costs to consumers of comprehending a contract. Comprehension would be determined based on judgements about which terms of the contract are material. Regulators would design an examination to test consumer comprehension and would set criteria for what constitutes a “passing” score on the exam.

In addition, regulators would set a minimum percent of consumers who would need to pass the examination for the contract to be used. Contractual efficiency is a function of the percent of consumers who comprehend the contract. Regulators would therefore determine the percent of consumers who must understand the contract based on the degree of tolerance for inefficient contracts.

To measure the cost of comprehension we suggest using the monetary cost of time.³⁹ Consumers have two choices: they can read the contract themselves or hire a lawyer to explain the contract.⁴⁰ Rational consumers would choose the least expensive approach that lets them understand. Consumers could consult contract summaries prepared by intermediaries, but these might suffer from misaligned incentives, quality problems, and high search costs. On the other hand, if such summaries are helpful, sellers can incorporate them into the contract to reduce the tax.

If consumers are familiar with a contract—for example from prior experience—then consumers should be able to pass the comprehension test while spending minimal time reading the contract, and the tax will be accordingly low. If sellers use the same contract repeatedly and communal knowledge grows, sellers could request a tax reassessment.

Regulators would need to determine the costs of direct and assisted readership. These costs could be estimated by testing a representative consumer sample. The sample should consist of consumers who buy products similar to those governed by the seller’s contract. Regulators could obtain data from sellers to construct the sample. Sellers typically have

³⁸ We use the monetary cost of time as a proxy for attention because time is easier to quantify. See generally THOMAS H. DAVENPORT & JOHN C. BECK, *THE ATTENTION ECONOMY: UNDERSTANDING THE NEW CURRENCY OF BUSINESS* (2001).

³⁹ *Id.*

⁴⁰ Although consumers may obtain an explanation from sellers, such an explanation might be biased.

extensive data profiling actual and potential customers⁴¹ to target their marketing efforts.⁴² Regulators could require sellers to share this information⁴³ and use similar targeting techniques. If sellers do not have this information, regulators could make inferences about likely consumer demographics from government surveys (the Consumer Expenditure Survey; the Survey of Consumer Finances; location information combined with Census data) or from private information available from data brokers.⁴⁴

Sampled consumers would be randomly assigned to one of two balanced groups. Half would be assisted by lawyers, and half would read unassisted. If sellers believe that third party reviews or output from AI readers could reduce consumers' comprehension costs,⁴⁵ then sellers may include such reviews as attachments. Consumers would then be surveyed about their comprehension of the terms and their legal implications.⁴⁶ Sellers attaching reviews for purposes of tax evaluation would need to show the same reviews whenever they presented the contract to consumers.

The costs of comprehending contracts without assistance would be the

⁴¹ Amy J. Schmitz, *Secret Consumer Scores and Segmentations: Separating Consumer 'Haves' from 'Have-Nots'*, 2014 MICH. ST. L. REV. 1411 at 1419–33 (2014); BAR-GILL, *SEDUCTION BY CONTRACT*, *supra* note 14.

⁴² OMRI BEN-SHAHAR & ARIEL PORAT, *PERSONALIZED LAW: DIFFERENT RULES FOR DIFFERENT PEOPLE* (2021).

⁴³ Relevant information might include income, education level, age, race, sex, residence, place of work, place of birth, English fluency or occupation.

⁴⁴ Steven Melendez & Alex Pasternack, *Here Are the Data Brokers Quietly Buying and Selling Your Personal Information*, FAST COMPANY (Mar. 2, 2019), <https://www.fastcompany.com/90310803/here-are-the-data-brokers-quietly-buying-and-selling-your-personal-information> [<https://perma.cc/7C5L-56RF>].

⁴⁵ See Yonathan A. Arbel & Shmuel I. Becher, *Contracts in the Age of Smart Readers*, 90 GEO. WASH. L. REV. 83 (2022); Rory Van Loo, *Digital Market Perfection*, 117 MICH. L. REV. 815 (2019); *cf.* Andrew D. Selbst, *Negligence and AI's Human Users*, 100 B.U. L. REV. 1315, 1351 (2020); Lawrence A. Zelenak, *Complex Tax Legislation in the TurboTax Era*, 1 COLUM. J. TAX L. 91 (2010).

⁴⁶ For proposals to survey consumers in similar contexts, *see, e.g.*, Ayres & Schwartz, *supra* note 6, at 606; Omri Ben-Shahar & Lior Jacob Strahilevitz, *Interpreting Contracts via Surveys and Experiments*, 92 N.Y.U. L. REV. 1753, 1766 (2017); Lauren E. Willis, *Performance-Based Remedies: Ordering Firms to Eradicate Their Own Fraud*, 80 L. & CONTEMP. PROBS. 7, 25 (2017).

marginal opportunity costs⁴⁷ of consumers' time.⁴⁸ If consumers need a lawyer to understand, then the tax would reflect both the lawyer's fees and the value of the time it takes the consumer to hire the lawyer and then listen to the lawyer and comprehend.

This method would be used to establish a per-customer quasi-Pigouvian tax based on the least expensive comprehension option in which consumer comprehension exceeds the minimum threshold. Sellers would pay this tax *every* time they presented the contract to consumers, regardless of whether they ultimately signed it.⁴⁹ Taxing based on the presentation of a contract to consumers—regardless of whether or not a consumer ultimately chooses to transact—more accurately reflects the comprehension costs imposed on consumers. This approach penalizes sellers who present low-quality contracts and encourages them to improve contract quality.

B. Enforcement and Compliance

Imposing a new tax requires authorities to ensure compliance.⁵⁰ Compliance can be encouraged through auditing⁵¹ and high penalties for willful tax evasion.⁵² Audit effectiveness can often be increased by targeted

⁴⁷ Consumers' opportunity costs should be measured on the margin because these costs increase as free time decreases. Marginal opportunity costs could be estimated based on consumers' hourly earnings increased by a multiplier, similar to overtime pay calculations. Overtime pay premiums are in part compensation for increased marginal disutility of work. See ROBERT A. HART, *THE ECONOMICS OF OVERTIME WORKING* 1, 81 (2004).

⁴⁸ It is unclear whether this should include all consumers or only the subset who actually understand the contract. The latter approach may be sufficient to estimate the cost of creating a critical mass of consumers to police contractual efficiency.

⁴⁹ To avoid paying the fee, sellers may delay presenting the contract until they are confident that a sale is likely. However, in many contexts, sellers already do this to increase sales (for example, by creating a "sunk cost" for consumers). Thus, our proposal would not significantly change sellers' practices.

⁵⁰ Joel Slemrod, *Cheating Ourselves: The Economics of Tax Evasion*, 21 J. ECON. PERSP. 25 (2007).

⁵¹ Several studies demonstrate the relationship between audits and compliance. See e.g., Joel Slemrod, Marsha Blumenthal & Charles Christian, *Taxpayer Response to an Increased Probability of Audit: Evidence from a Controlled Experiment in Minnesota*, 79 J. PUB. ECON. 455 (2001); Jeffrey Dubin, Michael Graetz & Louis Wilde, *The Effect of Audit Rates on the Federal Individual Income Tax, 1977–1986*, 43 NAT'L TAX J. 395 (1990); Henrik Jacobsen Kleven et al., *Unwilling or Unable to Cheat? Evidence From a Tax Audit Experiment in Denmark*, 79 ECONOMETRICA 651 (2011).

⁵² Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968); Margaret H. Lemos, *Special Incentives to Sue*, 95 MINN. L. REV. 782 (2011); Mitchell

auditing rather than a purely random audit approach. For example, targeted auditing may include auditing more at very high and very low reported transaction volume,⁵³ or auditing more when the tax imposed per contract is relatively high.⁵⁴ Regulators can also enhance compliance by increasing taxpayers' perceptions of audit and penalty risk.⁵⁵ Sanctions may vary based on dimensions of taxpayer behavior such as associated moral culpability, magnitude of evasion, good faith efforts to comply, and history of previous offenses.⁵⁶

Detection of non-compliance can be greatly increased through third-party information reporting or effective mechanisms to reward and protect whistleblowers.⁵⁷ For example, third-party reporting by employers of employee wages on W-2 forms and contractor pay on 1099 forms has dramatically reduced under-reported income.⁵⁸ Credit card reporting of transaction data has had a similar effect on small business income

Polinsky & Steven Shavell, *The Economic Theory of Public Enforcement of Law*, 38 J. ECON. LIT. 45 (2000). Some have expressed skepticism about the effectiveness of sanctions in deterring tax evasion. Giuseppe Dari-Mattiacci & Alex Raskolnikov, *Unexpected Effects of Expected Sanctions*, J. LEGAL STUD. (2021).

⁵³ Jennifer F. Reinganum & Louis L. Wilde, *Income Tax Compliance in a Principal-Agent Framework*, 26 J. PUB. ECON. 1–18 (1985) (advocating audit cutoff rules targeting very high and very low incomes).

⁵⁴ Joel Slemrod, *An Empirical Test for Tax Evasion*, 67 REV. ECON. & STAT. 232–238 (1985) (finding some evidence of higher levels of tax evasion at higher tax rates).

⁵⁵ Maciej H. Kotowski, David A. Weisbach & Richard J. Zeckhauser, *Audits as Signals*, 81 U. CHI. L. REV. 179 (2014); Joshua D. Blank & Daniel Z. Levin, *When is Tax Enforcement Publicized*, 30 VA. TAX REV. 1 (2010) (finding that tax enforcement is heavily publicized shortly before tax filing deadlines to increase taxpayer perceptions of audit risk); Michele Bernasconi, *Tax Evasion and Orders of Risk Aversion*, 67 J. PUB. ECON. 123–134 (1998).

⁵⁶ Alex Raskolnikov, *Six Degrees of Graduation: Law and Economics of Variable Sanctions*, 43 FLA. ST. U. L. REV. 1015 (2015); Michael J. Graetz & Louis L. Wilde, *The Economics of Tax Compliance: Fact and Fantasy*, 38 NAT'L TAX J. 355 (1985).

⁵⁷ Joel Slemrod & Shlomo Yitzhaki, *Chapter 22 - Tax Avoidance, Evasion, and Administration*, 3 in HANDBOOK PUB. ECON. 1423 (Alan J. Auerbach & Martin Feldstein eds., 2002); Lawrence A. Zelenak, *Tax Enforcement for Gamers: High Penalties or Strict Disclosure Rules?*, 109 COLUM. L. REV. 55 (2009) (discussing mandatory disclosures of possible tax shelters); Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695–744 (2007).

⁵⁸ Bibek Adhikari, James Alm, Brett Collins, Michael Sebastiani, & Eleanor Wilking, *Taxpayer Responses to Third-Party Income Reporting: Evidence from a Natural Experiment in the Taxicab Industry*. *IRS Research Bulletin*, 6th Annual Joint Research Conference on Tax Administration (2016) (pp. 3–8). Washington, DC: Internal Revenue Service and the Urban-Brookings Tax Policy Center (finding that the introduction of form 1099-K dramatically increased taxi drivers' reporting of gross income and deductible expenses).

reporting.⁵⁹ There is also evidence that rewards to consumers can induce them to report on tax-evading sellers if it is easy for consumers to do so.⁶⁰

Collection costs are typically reduced by pre-payments (for example, through tax withholding), with refunds or adjustments later.⁶¹ Thus, sellers could be required to prepay for their anticipated contract usage. Excess payments could then be refunded on a quarterly or annual basis.

There is some evidence, albeit mixed, that perceptions of fairness and social norms may help increase compliance.⁶² Thus, a messaging campaign accompanying the introduction of the new tax—explaining its justifications and periodically reinforcing it—could be helpful.⁶³ Because consumers generally believe that it is unfair for sellers to bind consumers to long and complicated contracts,⁶⁴ it would likely be relatively easy to enlist whistleblowers to report on non-compliant businesses.

Relatedly, Raskolnikov and others have argued that enforcement resources can be used in a more efficient and targeted way by first inducing taxpayers to sort themselves into groups by probability of tax evasion.⁶⁵ In particular, he proposes that taxpayers be offered a tradeoff in which they can

⁵⁹ Joel Slemrod et al., *Does Credit-Card Information Reporting Improve Small-Business Tax Compliance?*, 149 J. PUB. ECON. 1 (2017).

⁶⁰ Carla Marchese, *Rewarding the Consumer for Curbing the Evasion of Commodity Taxes?*, 65 PUB. FIN. ANALYSIS 383 (2009) (consumers in China were given lottery tickets on receipts. Seller generation of a receipt provided a report to tax authorities.); see Joana Naritomi, *Consumers as Tax Auditors*, 109 AM. ECON. REV. 3031 (2019) (describing a program in Brazil that rewarded consumers who blew the whistle on tax-evading businesses that increased reported sales by 21 percent over four years).

⁶¹ Gideon Yaniv, *Tax Compliance and Advance Tax Payments: A Prospect Theory Analysis*, 52 NAT'L TAX J. 753 (1999); Kim C. Border & Joel Sobel, *Samurai Accountant: A Theory of Auditing and Plunder*, 54 REV. ECON. STUD. 525 (1987).

⁶² Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. TAX. REV. 1781 (2000); Robert Cooter, *Do Good Laws Make Good Citizens? An Economic Analysis of Internalized Norms*, 86 VA. TAX. REV. 1577 (2000); Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453 (2003) (arguing that enforcement and norms are mutually reinforcing); cf. Alex Raskolnikov, *The Cost of Norms: Tax Effects of Tacit Understandings*, 74 U. CHI. L. REV. 601 (2007) (arguing that unwritten agreements between businesspeople undermine tax enforcement and proposing that these agreements be treated as legally binding).

⁶³ David Schizer & Yair Listokin, *I Like to Pay Taxes: Taxpayer Support for Government Spending and the Efficiency of the Tax System*, 66 TAX L. REV. 179 (2013) (arguing that the government should publicize popular uses of tax dollars).

⁶⁴ See Furth-Matczkin and Sommers, *supra* note 15.

⁶⁵ Alex Raskolnikov, *Revealing Choices: Using Taxpayer Choice to Target Tax Enforcement*, 109 COLUM. L. REV. 689 (2009); Lawrence Zelenak, *Tax Enforcement for Gamers: High Penalties or Strict Disclosure Rules Response*, 109 COLUM. L. REV. SIDEBAR 55–64 (2009) (arguing that the tax regime should use variable disclosure requirements rather than variable penalties to distinguish between high-evasion risk and low-evasion risk taxpayers).

reduce the potential penalties they might face for violations by credibly committing up front to greater cooperation with tax authorities.⁶⁶

Along these lines, we propose that sellers be required to display a symbol on their contracts indicating whether or not they have paid the tax. A database would also be available to the public to check which sellers have paid the tax for which contracts. Members of the public whose non-compliance reports lead to successful enforcement actions could receive a fee similar to a whistleblower reward.⁶⁷

Sellers who forget to pay the tax and do not display the symbol would be quickly detected and reported. Because such omissions by the seller would likely be due to innocent mistakes, and the probability of detection would be high, such sellers could be penalized lightly.⁶⁸ On the other hand, sellers who fraudulently display the symbol while not paying the tax would be more difficult to detect and should accordingly be penalized more severely.⁶⁹

Larger, more established firms would likely be more compliant than smaller players because of the higher probability of detection.⁷⁰ To further increase deterrence, consumers could be authorized to bring class actions or multi-district litigation against non-compliant sellers.⁷¹ This could

⁶⁶ Raskolnikov, *supra* note 114.

⁶⁷ These rewards are typically structured as a percent of the amount collected. See Yehonatan Givati, *A Theory of Whistleblower Rewards*, 45 J. LEGAL STUD. 43 (2016).

⁶⁸ For example, sellers might be obligated to pay taxes that were previously due (with a market rate of interest), in addition to a small penalty to increase deterrence.

⁶⁹ A number of scholars have argued that it may be politically difficult to impose large sanctions. In this context, for example, a seller might argue that it had innocently forgotten to remove the stamp when creating a contract based on a template of an older contract that had been approved. It should be possible to minimize such claims by only applying the stamp to formats that cannot readily be edited. Joseph Bankman, *Eight Truths About Collecting Taxes from the Cash Economy*, 117 TAX NOTES 506, 514–15 (2007); see also Slemrod, *Cheating Ourselves*, *supra* note 99, at 43 (suggesting that popular notion that punishment be proportional to harm may make courts reluctant to apply stiff penalties needed to assure sufficient levels of deterrence).

⁷⁰ Susan Cleary Morse, Stewart Karlinsky & Joseph Bankman, *Cash Businesses and Tax Evasion*, 20 STAN. L. & POL'Y REV. 37, 38 (2009) (finding that small business owners report less than half of their income); see also Francesco Trebbi, Miao Ben Zhang & Michael Simkovic, *The Cost of Regulatory Compliance in the United States* (Nat'l Bureau of Econ. Rsch., Working Paper No. 30691, 2023) (finding that small firms spend less on regulatory compliance than mid-size and large firms). Consumers recognizing this may rely on larger firms to offer better (shorter, simpler) contracts.

⁷¹ John C. Coffee, *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law through Class and Derivative Actions*, 86 COLUM. L. REV. 669 (1986); Troy A. McKenzie, *Toward a Bankruptcy Model for Nonclass Aggregate Litigation*, 87 N.Y.U. L. REV. 960 (2012).

supplement regulatory enforcement measures and keep enforcement levels steadier across political cycles.⁷²

In addition, the introduction of a tax on consumer contracts could assist with the collection of income and sales taxes. As previously noted, small business owners dramatically under-report their incomes.⁷³ If these small businesses wish to use contracts, however, then the enforcement regime tied to collecting the tax on contracts would also generate information useful for collecting income and sales taxes. In effect, with the tax in place, consumer contracts would become a “friction” which would prevent tax evasion.⁷⁴

One concern is that consumers could misunderstand the symbol to mean that a seller’s contract was pro-consumer rather than merely that the seller had paid the tax. Possible misinterpretation of the symbol would need to be mitigated through consumer education.⁷⁵

Symbols that indicate tax payment are effective in facilitating tax enforcement. Stamp taxes on printed materials were successfully used in Holland and the United Kingdom with enforcement technology from hundreds of years ago.⁷⁶ Stamp taxes were also used by state governments within the United States,⁷⁷ and continue to be used in developing economies.⁷⁸

⁷² See, e.g., James D. Cox & Randall S. Thomas, *Corporate Darwinism: Disciplining Managers in a World with Weak Shareholder Litigation*, 95 N.C. L. REV. 19 (2016) (arguing that private litigation can reinforce collective governance by diffuse groups); cf. Margaret H. Lemos, *Privatizing Public Litigation*, 104 GEO. L.J. 515 (2016) (critiquing the use of private incentives and market actors in public litigation).

⁷³ See Morse, Karlinsky & Bankman, *supra* note 119.

⁷⁴ David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312–1409 (2001).

⁷⁵ For example, consumers generally do not assume that a company displaying the registered trademark symbol has stronger approval from the government for the underlying product than those not displaying this symbol.

⁷⁶ Alden L. Powell, *National Stamp-Tax Laws and State Instrumentalities*, 29 AM. POL. SCI. REV. 225–246 (1935).

⁷⁷ Lewis Hopkins Rogers, *Stamp Tax on Shares of No Par Value*, 95 CENT. L.J. 445 (1922); Mack Thompson, *Massachusetts and New York Stamp Acts*, 26 WM. & MARY Q. 253–258 (1969).

⁷⁸ Ian Davidoff & Andrew Leigh, *How Do Stamp Duties Affect the Housing Market?*, 89 ECON. RECORD 396–410 (2013); ERVI LIUSMAN & DANIKA WRIGHT, *The Real Impact of Residential Property Stamp Duties*, ERES (2017); Wei Cui, *Taxing Indirect Transfers: Improving an Instrument for Stemming Tax and Legal Base Erosion*, 33 VA. TAX REV. 653–700 (2013) (noting that stamp-tax like taxes continue to be used in developed economies to tax transfers of ownership in real estate).

With modern technology, enforcement could be more effective.⁷⁹ For example, sellers could be required to collect contract signatures from consumers through a system such as DocuSign,⁸⁰ which would be obligated to report contracts to the government.⁸¹ The use of such electronic contracting could streamline detection of non-compliant sellers and make it easier for consumers to spot problems and blow the whistle.

Similarly, consumers collecting the reward for reviewing the contract would provide information that would induce sellers to comply.⁸² Analogously, Value Added Taxes encourage compliance through greater third-party reporting from intermediate producers who need receipts to claim tax deductions.⁸³ The enforcement system for a tax on contracts would also facilitate enforcement of sales and income taxes.⁸⁴

C. State v. Federal Administration

Pigouvian contracts could be administered either at the state or federal level. We believe that on balance, federal administration would be preferable, but state administration, including in only some states, would not present a significant disadvantage.

⁷⁹ J. Satyanarayana, *Computer-Aided Registration of Deeds and Stamp Duties*, in INFORMATION AND COMMUNICATION TECHNOLOGY IN RURAL DEVELOPMENT 48–65 (Subhash Bhatnagar & Robert Schware eds., 2000).

⁸⁰ DocuSign, <https://www.docusign.com/company>

⁸¹ Note that the Consumer Financial Protection Bureau already maintains a database of credit card agreements. CFPB Credit Card Agreement Database, <https://www.consumerfinance.gov/credit-cards/agreements/>. Some states' laws require that mortgages be recorded in full in the state's land registration system. Michael Simkovic, *Secret Liens and the Financial Crisis of 2008*, 83 AM. BANKR. L.J. 253 (2009).

⁸² Marcelo Arbex & Enlison Mattos, *Optimal Sales Tax Rebates and Tax Enforcement Consumers*, 67 OXFORD ECON. PAPERS 479 (2015) (presenting a model showing that sales tax rebates to consumers induces greater reporting).

⁸³ Dina Pomeranz, *No Taxation without Information: Deterrence and Self-Enforcement in the Value Added Tax*, 105 AM. ECON. REV. 2539 (2015). Tax reformers increasingly prefer consumption taxes to income taxes. Daniel Shaviro, *Beyond The Pro-Consumption Tax Consensus*, 60 STAN. L. REV. 745 (2007); *see also supra* note 58 to 59.

⁸⁴ It may be easier to enforce sales or revenue taxes than income taxes because businesses can readily increase reported deductions when they are forced to increase reported income. Paul Carrillo, Dina Pomeranz & Monica Singhal, *Dodging the Taxman: Firm Misreporting and Limits to Tax Enforcement*, 9 AM. ECON. J. APPLIED ECON. 144 (2017).

1. Variation across states

State administration tends to be advantageous when populations are heterogeneous across states and relatively homogenous within states.⁸⁵ However, if consumer preferences or comprehension abilities varied substantially by state, businesses could create different contracts for residents of each state.⁸⁶ With state-specific contracts, even if the program were administered at the federal level, the tax would vary by state.

Thus, variation between consumers in different states *does not* favor contract evaluation at the state level. To the contrary, if sellers use a single uniform contract across states, economies of scale favor initial contract evaluation at the federal level. The contract evaluator would need to use a representative group of consumers. The Federal Government already has extensive experience with statistical sampling, for example in the conduct of various Census surveys, and is competent to conduct the proposed consumer surveys.

2. Experimentation at the state level

A more persuasive argument in favor of state involvement is the need for experimentation and learning under conditions of imperfect information.⁸⁷ Experimentation at the state level can be a relatively low-stakes way to generate information about the efficacy of new policies, before they are implemented at the national level.

The main downside to state-level administration is loss of economies of scale. But large states, such as California, New York, Texas, Florida and Illinois, probably have more than sufficient scale to implement the proposal.⁸⁸ Moreover, a single economically important state can influence how businesses conduct their affairs nationally.⁸⁹

⁸⁵ Wallace E. Oates, *An Essay on Fiscal Federalism*, 37 J. ECON. LIT. 1120–1149 (1999); WALLACE E. OATES, *FISCAL FEDERALISM* (2011); Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416–424 (1956); Ruth Mason, *Delegating Up: State Conformity with the Federal Tax Base*, 62 DUKE L.J. 1267 (2012).

⁸⁶ Numerous firms already offer state-specific residential leases. See, e.g., Internet Legal Research Group, <https://www.ilrg.com/forms/lease-res/us> [<https://perma.cc/UD6U-HKF7>]. Outside of a handful of areas, such as residential leases or mortgages, businesses generally do not choose to divide customers in this way.

⁸⁷ Wallace E. Oates, *An Essay on Fiscal Federalism*, 37 J. ECON. LIT. 1120, 1132 (1999).

⁸⁸ GDP BY STATE, U.S. BUREAU OF ECONOMIC ANALYSIS (BEA).

⁸⁹ For example, California's relatively consumer-friendly privacy policies may change

On the other hand, central governments can sponsor limited field experiments⁹⁰ and examine whether programs are likely to work at scale.⁹¹ When national governments are entrepreneurial, states are not necessarily ideal “laboratories.”⁹²

3. State tax competition

If the tax were administered at the state level, then competition between states might keep taxes on contracts low. If taxes were apportioned based on state of incorporation, corporate headquarters, or location of employees, then sellers could trigger a “race to the bottom” by fleeing to low tax states.⁹³ However, if taxation were based on the residence of the consumer, competition would more likely pressure states to keep taxes at efficient levels.⁹⁴

contracts used with consumers outside of California. See, e.g., JACK GOLDSMITH & TIM WU, WHO CONTROLS THE INTERNET? ILLUSIONS OF A BORDERLESS WORLD (2006), at 176; ANU BRADFORD, THE BRUSSELS EFFECT: HOW THE EUROPEAN UNION RULES THE WORLD (2020).

⁹⁰ Michael Hallsworth, *The Use of Field Experiments to Increase Tax Compliance*, 30 OXFORD REV. ECON. POL’Y 658 (2014); John A. List & Imran Rasul, *Chapter 2 - Field Experiments in Labor Economics*, 4 in HANDBOOK LAB. ECON. 103 (Orley Ashenfelter & David Card eds., 2011).

⁹¹ JOHN A. LIST, THE VOLTAGE EFFECT: HOW TO MAKE GOOD IDEAS GREAT AND GREAT IDEAS SCALE (2022)(discussing the failure of many programs that work on a small scale to scale up, and ways of testing the marginal effects of programs and ascertaining whether they are likely to be workable at a large scale).

⁹² Indeed, natural experiments from variation in state law often suffer from endogeneity concerns that complicate causal inference. Marianne Bertrand, Esther Duflo & Sendhil Mullainathan, *How Much Should We Trust Differences-In-Differences Estimates?*, 119 Q. J. ECON. 249 (2004); Michael Simkovic & Eric Allen, *Work Hours & Income Tax Cuts: Evidence from Federal-State Tax Interactions*, 25 FLA. TAX REV. 388 (2021) (using a novel setting of federal-state tax interactions to mitigate endogeneity concerns).

⁹³ State governments and smaller national governments notoriously compete to offer mobile businesses the lowest tax rates and highest levels of services. Wallace E. Oates, *An Essay on Fiscal Federalism*, 37 J. ECON. LIT. 1120 (1999) (discussing the limitations on redistributive taxes and non-benefit taxes created by mobile tax bases); Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573 (2000) (arguing that global tax competition would undermine funding for anti-poverty and economic security programs); Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699 (2011) (discussing the mechanics of international corporate income tax avoidance); cf. Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416–424 (1956) (arguing that tax competition produces optimal levels of taxes and services for heterogeneous taxpayers).

⁹⁴ See, e.g., Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the “Race-*

D. Constitutional Challenges

1. Is a tax on contracts a “direct tax”?

The U.S. Constitution requires that “direct taxes” be “apportioned,” or proportionate to state, population.⁹⁵ Federal income taxes are explicitly exempt from this apportionment requirement under the Sixteenth Amendment.

If a tax on contracts were a “direct tax,” then administering it at the Federal level would be more costly and less effective. Federal administration would require either post-hoc adjustments to satisfy apportionment,⁹⁶ or shoe-horning contracts taxes into federal income taxes.⁹⁷ Such awkward solutions would not be required to administer contract taxes at the state level.

Fortunately, case law suggests that a tax on contracts is not a “direct tax.”⁹⁸ The Supreme Court has held that a tax on expenditures does not constitute a “direct” tax, but rather a constitutionally permissible duty or excise tax.⁹⁹ The Court went on to list examples of direct taxes: head taxes

to-the Bottom” Rationale for Federal Environmental Regulation, 67 NYU L. Rev. 1210 (1992) (critiquing “race-to-the-bottom” arguments against state, rather than federal, regulation in certain contexts).

⁹⁵ U.S. CONST. art. I, § 9 (“[n]o Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.”); U.S. CONST. amend. XVI (“[t]he Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.”).

⁹⁶ See, e.g., Ari Glogower, David Gamage & Kitty Richards, *Why a Federal Wealth Tax is Constitutional* (Ohio St. Legal Stud., Research Paper No. 623, 2021) (discussing workarounds to the direct tax apportionment problem); see also John R. Brooks & David Gamage, *Taxation and the Constitution Reconsidered*, 76 TAX L. REV. 75 (2022) (discussing workarounds to the direct tax apportionment problem).

⁹⁷ This could operate, for example, through the denial of tax deductions or a more onerous income tax schedule for businesses using consumer contracts.

⁹⁸ *Hylton v. United States*, 3 U.S. 171 (1796) (“[a]ll taxes on expenses or consumption are indirect taxes. A tax on carriages is of this kind, and of course is not a direct tax. Indirect taxes are circuitous modes of reaching the revenue of individuals, who generally live according to their income.”).

⁹⁹ *Id.*

and taxes on land.¹⁰⁰ Subsequent case law added the income tax to the list.¹⁰¹

A tax on contracts, imposed on sellers, is effectively a tax on elective expenditures.¹⁰² The costs of drafting a contract and presenting it to consumers are “legal expenses” of sellers.¹⁰³ The costs of understanding contracts are costs faced by consumers. Thus, constitutional limits on “direct” taxes should not preclude the Federal government from taxing consumer contracts.

2. Does the First Amendment prohibit a tax on contracts?

The First Amendment applies to both federal and state governments. A successful challenge on First Amendment grounds would therefore prevent the tax we propose from being implemented at any level of government. But would a tax on contracts violate the First Amendment?

The First Amendment provides that “Congress shall make no law ... abridging the freedom of speech.”¹⁰⁴ This raises the question: are contracts a form of constitutionally protected speech? And if so, does imposing a tax abridge a seller’s constitutionally protected freedom of speech? Sellers (whether individuals or corporations) have a constitutionally protected right to engage in political free speech.¹⁰⁵

However, Commercial Contracts are not a form of political speech. The Federal Government imposes many established, widely accepted restrictions on business communications. Anti-fraud statutes are a form of speech regulation.¹⁰⁶ Plain language rules and disclosure requirements, such as those

¹⁰⁰ *Id.* (“[w]hat are direct taxes within the meaning of the Constitution? The Constitution declares that a capitation tax is a direct tax, and both in theory and practice a tax on land is deemed to be a direct tax I never entertained a doubt that the principal ... objects that the framers of the Constitution contemplated as falling within the rule of apportionment were a capitation tax and a tax on land. Local considerations and the particular circumstances and relative situation of the states naturally lead to this view....”).

¹⁰¹ *Pollock v. Farmers’ Loan & Trust Co. et al.*, 157 U.S. 429, 586 15 S.Ct. 673 (1895); *Brushaber v. Union P. R. Co.*, 240 U.S. 1, 19 (1916) (deciding that income tax is a direct tax).

¹⁰² Transactions can often be consummated under default rules, without the need for anything more than agreement on price and quantity. Simkovic & Furth-Matzkin, *supra* note 1.

¹⁰³ Legal expenses are a type of “selling, general, and administrative expenses” (SG&A). See 1 *Atty’s Handbook of Acct, Auditing and Fin Rep* § 4.04 (2020).

¹⁰⁴ U.S. CONST. amend. I.

¹⁰⁵ *Citizens United v. Fed. Election Comm’n*, 558 U.S. 310 (2010).

¹⁰⁶ Federal Trade Commission Act, 15 U.S.C. §§ 41-58 (authorizing action by the FTC to prevent consumer fraud); Dee Pridgen, *The Dynamic Duo of Consumer Protection: State and Private Enforcement of Unfair and Deceptive Trade Practices Laws*, 81 ANTITRUST L.J. 911,

imposed by the Securities and Exchange Commission on listed companies, are also forms of speech regulation.¹⁰⁷ Mandates requiring disclosure with specific formats are generally accepted.¹⁰⁸ The possible exception to this rule is the controversy surrounding mandatory graphic warnings on cigarette packages that are meant to dissuade consumers from purchasing cigarettes.¹⁰⁹

Our proposal is less restrictive than many widely accepted laws and regulations. A tax would neither mandate nor ban specific contractual provisions. Sellers would be free to draft contracts as they deem fit, subject to paying a tax proportionate to comprehension costs imposed on consumers. This is no more burdensome than requiring broadcasters to bid for the right to communicate using certain limited ranges of the electromagnetic spectrum.¹¹⁰

911 (2016) (“[s]tate consumer protection statutes, otherwise known as Unfair and Deceptive Acts or Practices (UDAP) laws, have been on the books of all states for some 40-plus years.”); National Consumer Law Center, *Unfair and Deceptive Acts and Practices* (9th ed. 2016) <https://www.nclc.org/issues/unfair-a-deceptive-acts-a-practices.html> [<https://perma.cc/8PWQ-49YL>] (“In billions of transactions annually, UDAP statutes provide the main protection to consumers against predators and unscrupulous businesses.”).

¹⁰⁷ SECURITIES AND EXCHANGE COMMISSION, *PLAIN ENGLISH DISCLOSURE, FINAL RULE*, 17 CFR Parts 228, 229, 230, 239 and 274, October, 1998, available at <https://www.sec.gov/rules/final/33-7497.txt> [<https://perma.cc/58SV-WJWR>].

¹⁰⁸ For example, the Truth in Lending Act (TILA), 15 U.S.C. 1601 *et seq.*, requires prominent disclosures of a standardized interest rate, the Annual Percentage Rate, to facilitate competition in consumer lending. See FEDERAL RESERVE BOARD, *REGULATION Z, TRUTH IN LENDING*, INTRODUCTION at 3, available at https://www.federalreserve.gov/boarddocs/caletters/2008/0805/08-05_attachment1.pdf [<https://perma.cc/K59V-9DY6>]; see also 15 U.S.C. § 1601(a).

¹⁰⁹ Whether controversial mandatory disclosures that are against sellers’ commercial interests, such as graphic cancer warnings on cigarettes, will survive constitutional challenges remains to be seen. *R.J. Reynolds, et al. v. Food and Drug Administration*, 696 F.3d 1205 (D.C. Cir. 2012); *Philip Morris USA Inc. and Sherman Group Holdings v. Food and Drug Administration* (D.D.C., May 6, 2020); *R.J. Reynolds v. Food and Drug Administration* (E.D. Tex., April 23, 2020). On July 17, 2020, 25 state attorneys general filed a brief supporting FDA’s authority to require graphic warnings on cigarette packages. The bipartisan coalition argues that the FDA’s substantial interest in promoting awareness of the dangers of smoking and counteracting decades of deceptive behavior by the tobacco industry make the rule permissible under the First Amendment.

¹¹⁰ Thomas W. Hazlett, *Assigning Property Rights to Radio Spectrum Users: Why Did FCC License Auctions Take 67 Years?*, 41 J. L. & ECON. 529–576 (1998); Eli Noam, *Spectrum Auctions: Yesterday’s Heresy, Today’s Orthodoxy, Tomorrow’s Anachronism. Taking the Next Step to Open Spectrum Access*, 41 J. L. & ECON 765 (1998) (proposing congestion pricing for information transmission rather than exclusive licensing); Stuart Minor Benjamin, *Spectrum Abundance and the Choice between Private and Public Control*, 78 N.Y.U. L. REV. 2007 (2003) (arguing that spectrum commons are unattractive because of interference).

Federal regulations of consumer contracts, such as the Magnuson Moss Warranty Act, have never been successfully constitutionally challenged,¹¹¹ nor have state law equivalents.¹¹² Similarly, substantive regulations of credit card agreements¹¹³ or mortgages,¹¹⁴ which—like taxes—impose costs on sellers, have not been successfully challenged on constitutional grounds. Such regulations are authorized under the powers of Congress to regulate interstate commerce and to promote the general welfare.¹¹⁵ Moreover, Congress has plenary authority to impose taxes.¹¹⁶ Therefore, the First Amendment would not preclude a federal or state tax on contracts.

3. Does the Dormant Commerce Clause prevent states from taxing contracts?

The Commerce Clause of the U.S. Constitution has been held to prohibit state governments from imposing discriminatory taxes against out-of-state businesses, thereby interfering with interstate commerce.¹¹⁷ The rationale is that the regulation of interstate commerce falls within the

¹¹¹ Magnuson-Moss Warranty—Federal Trade Commission Improvement Act, 15 U.S.C. §§2301–2312 (1976). The FTC has enacted rules concerning the disclosure of product warranties. See 16 C.F.R. Part 700.

¹¹² U.C.C. § 2–216(2) (“ . . . to exclude or modify the implied warranty of merchantability or any part of it the language must mention merchantability and in case of a writing must be conspicuous. . . ”).

¹¹³ Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. No. 111-24, 123 Stat. 1734, codified in relevant part to 15 U.S.C. §§ 1601-1667f, 1681 et seq. and 1693 et seq (Credit CARD Act) (banning certain billing practices); Michael Simkovic, *Credit Card Reform and Bankruptcy Reform*, 1 NORTON BANKR. L. ADVISER 1 (2009).

¹¹⁴ Disclosure rules apply to mortgages and other real estate services under TILA and RESPA. Truth in Lending Act, 15 U.S.C. ch. 41 § 1601 (1968) as amended; Real Estate Settlement Procedures Act, 12 U.S.C. §§ 2601–2617 (1974).

¹¹⁵ U.S. CONST. art. I, § 8.

¹¹⁶ Gillian E. Metzger, *To Tax, to Spend, to Regulate the Supreme Court 2011 Term: Comment*, 126 HARV. L. REV. 83 (2012); Jack M. Balkin, *The Constitutionality of the Individual Mandate for Health Insurance*, 362 NEW ENG. J. MED. 482–483 (2010); Erwin Chemerinsky, *Political Ideology and Constitutional Decisionmaking: The Coming Example of the Affordable Care Act* *The Constitutionality of the Affordable Care Act: Ideas from the Academy*, 75 LAW & CONTEMP. PROBS. 1 (2012); Lawrence O. Gostin, *Texas v United States: The Affordable Care Act Is Constitutional and Will Remain So*, 321 JAMA 332–333 (2019); Martha Minow, *Affordable Convergence: Reasonable Interpretation and the Affordable Care Act* *The Supreme Court 2011 Term: Comment*, 126 HARV. L. REV. 117 (2012).

¹¹⁷ Michael S. Knoll & Ruth Mason, *The Economic Foundation of the Dormant Commerce Clause*, 103 VA. L. REV. 309 (2017); Jesse H. Choper & Tung Yin, *State Taxation and the Dormant Commerce Clause: The Object-Measure Approach*, 1998 S. CT. REV. 193 (1998).

exclusive powers of the Federal Government.¹¹⁸

A tax on consumer contracts, levied uniformly on in-state and out-of-state businesses soliciting business from residents of a state, would be presumptively non-discriminatory. Opponents of the proposed tax could argue that the tax has a disproportionate impact on out-of-state businesses, as out-of-state businesses typically have a larger customer base and may therefore use more complex contracts.¹¹⁹ As a result, they may be taxed more heavily.

However, there is a rational basis for imposing a tax proportional to comprehension costs. Moreover, out-of-state sellers can mitigate any potentially discriminatory effect at a relatively low cost by using different contracts for customers in different states.¹²⁰ Thus, it seems unlikely that a constitutional challenge against a state-imposed tax would succeed on discrimination grounds.

In addition to non-discrimination, states were traditionally required to have a physical nexus with the entity taxed.¹²¹ This made it challenging for states to impose sales taxes on mail-order or online purchases.¹²² Such a requirement could similarly make it challenging for states to impose a tax on contracts between state residents and out-of-state businesses if the business lacks a physical presence within the state.

However, the physical nexus requirement was eliminated by the U.S. Supreme Court in its recent *Wayfair* decision.¹²³ In *Wayfair*, the Supreme Court validated South Dakota's efforts to collect sales taxes from the online furniture retailer, Wayfair, even though the seller did not have a physical presence within the state. *Wayfair* facilitates the imposition of taxes on transactions between state residents and non-resident businesses.¹²⁴

¹¹⁸ Donald H. Regan, *The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Clause*, 84 MICH. L. REV. 1091 (1986).

¹¹⁹ Simkovic & Furth-Matzkin, *supra* note 1.

¹²⁰ Jens Frankenreiter, *The Missing "California Effect" in Data Privacy Law*, 39 YALE J. REG. 1068 (2021) (finding that businesses differentiate their contracts for consumers in the U.S. versus the European Union and between California and non-California residents).

¹²¹ *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

¹²² Hayes R. Holderness, *Questioning Quill*, 37 VA. TAX REV. 313 (2017); Edward A. Zelinsky, *Rethinking Tax Nexus and Apportionment: Voice, Exit, and the Dormant Commerce Clause*, 28 VA. TAX REV. 1 (2008).

¹²³ *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2084 (2018) (stating that the holding in *Quill* is "unsound and incorrect.>").

¹²⁴ Kirk J. Stark, *Wayfair in Constitutional Perspective: Who Sets the Ground Rules of US Fiscal Federalism?*, 74 NAT'L TAX J. 221–256 (2021); Adam B. Thimmesch, Darien Shanske & David Gamage, *Wayfair: Sales Tax Formalism and Income Tax Nexus*, 89 ST. TAX NOTES 975 (2018).

Thus, the tax could constitutionally be administered at either the federal or the state level. It should be noted, however, that state-level taxation under *Wayfair* might still entail greater complexity and administrative costs than comparable federal taxation.¹²⁵

In particular, the dormant Commerce Clause also requires that taxes paid to each state be properly apportioned to the activity occurring in that state.¹²⁶ This requirement could probably be satisfied if each state implementing our proposal imposed a tax based on the contracts that a business presents to that state's residents.

However, some businesses might argue that another apportionment rule should apply.¹²⁷ Controversy regarding the appropriate apportionment rule would introduce litigation that would be obviated if the tax were administered at the federal level. This is another reason to prefer federal taxation but does not preclude states from independently adopting our proposal.

4. Does the Contracts Clause prevent states from taxing contracts?

The Contracts Clause of the U.S. Constitution provides that “[n]o State shall ... pass any Bill of Attainder, ex-post facto Law, or Law impairing the Obligation of Contracts.”¹²⁸ This provision prohibits state governments from abrogating the state's contractual obligations, such as its obligations to repay creditors.¹²⁹

During the late *Lochner* Era, in the 1930s, businesses sought to use the Contracts Clause to challenge economic regulation.¹³⁰ However, this line of cases has generally been overturned.¹³¹ Within the last few decades, the

¹²⁵ Whitney B. Afonso, *The Barriers Created by Complexity: A State-by-State Analysis of Local Sales Tax Laws in Light of the Wayfair Ruling*, 72 NAT'L TAX J. 777–800 (2019).

¹²⁶ Edward A. Zelinsky, *Rethinking Tax Nexus and Apportionment: Voice, Exit, and the Dormant Commerce Clause*, 28 VA. TAX REV. 1, 2 (2008).

¹²⁷ Sellers might prefer apportionment rules based on the business's headquarters, state of incorporation, where its contracts are drafted, or where its employees are located to increase competition between states and reduce taxes. See *supra* Part III.0.

¹²⁸ U.S. Constitution, art. I, Sec. X, Cl. 1.

¹²⁹ Stewart E. Sterk, *The Continuity of Legislatures: Of Contracts and the Contracts Clause*, 88 COLUM. L. REV. 647 (1988); Whitney Cloud, *State Pension Deficits, the Recession, and a Modern View of the Contracts Clause*, 120 YALE L.J. 2199 (2011).

¹³⁰ Paul G. Kauper, *What Is a “Contract” under the Contracts Clause of the Federal Constitution?*, 31 MICH. L. REV. 187 (1932).

¹³¹ *Honeywell, Inc. v. Minnesota Life and Health Ins. Guar. Ass'n*, 110 F.3d 547, 554-55 (8th Cir., 1997); *Powell v. State ex rel. Oregon Dept. of Land Conservation and Development*, 243 P.3d 798, 802 (2010); *In re American Freight System, Inc.*, 179 B.R. 952, 962-63 (1995).

Contracts Clause has not been interpreted to prevent state regulation of contracts between private parties.¹³² Indeed, *any* tax or regulation could affect contracting between private parties.

Thus, it seems implausible that the Contracts Clause could be used to challenge a tax on contracts. However, if such a challenge were to succeed, this would favor federal over state taxation.

E. Agency Expertise

The analysis above suggests that there are advantages to implementing Pigouvian taxation of contracts at the federal level, but that state-level taxation would still be effective. In this section, we turn our discussion from the appropriate level of government to specific agencies who could administer the tax.

1. Initial contract evaluation

Initial contract evaluation requires expertise in contractual interpretation, comprehension testing, statistical sampling, and survey methods.¹³³

Two federal agencies have the most extensive expertise in consumer contract interpretation—the Federal Trade Commission (FTC) and the Consumer Financial Protection Bureau (CFPB) of the Federal Reserve.¹³⁴ In addition, the State Attorney General’s Offices have similar competencies.¹³⁵

Of these agencies, only the FTC and the CFPB have expertise in statistical sampling and consumer surveys. The federal agencies with the greatest statistical expertise include the United States Census Bureau and the U.S. Department of Labor’s Bureau of Labor Statistics.¹³⁶ In addition, the Internal Revenue Service has extensive administrative data which can be matched with Census data.¹³⁷

¹³² Brenner M. Fissell, *The Dual Standard of Review in Contracts Clause Jurisprudence*, 101 GEO. L.J. 1089, 1090 (2012) (“a legislature’s repudiations of its own contracts [is reviewed] with heightened scrutiny. Legislative repudiations of private agreements, though, would be accorded substantially more deference.”).

¹³³ See Section III. Tax Administration & Institutional Design, subsections A through C, *supra*.

¹³⁴ Federal Trade Comm’n, *The Enforcers*, <https://www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws/enforcers>.

¹³⁵ *Id.*

¹³⁶ United States Census Bureau, *What We Do*, <https://www.census.gov/about/what.html>.

¹³⁷ Overview of BLS Statistics, <https://www.bls.gov/bls/overview.html>.

The agencies with the greatest expertise in curbing anti-competitive practices include the FTC, the Department of Justice Antitrust division, the CFPB, and States' Attorney Generals.¹³⁸ However, the FTC and Department of Justice (DOJ) tend to move slowly,¹³⁹ and typically focus on industry macro-structure, anti-competitive mergers, price fixing, and traditional anti-competitive practices.¹⁴⁰ The FTC and the DOJ have not adequately addressed novel industry approaches to reducing competition, such as the development of unreadable contracts.¹⁴¹

By contrast, the CFPB more actively and creatively protects consumers and promotes competition.¹⁴² For example, the CFPB created a free online tool which shows the range of mortgage interest rates for consumers with particular credit scores, income levels, and borrowing needs. This tool enables consumers to quickly find the lowest interest rate in the market. It consequently puts pressure on sellers to compete on price.¹⁴³

Thus, the CFPB may be the best equipped agency to handle initial contract evaluation, but other agencies could do so.

2. Tax collection & enforcement

IRS or state tax authorities are most suitable to set and collect the tax. Some state authorities, notably California, may more aggressively enforce tax compliance than the IRS.¹⁴⁴

¹³⁸ See *infra* note 174.

¹³⁹ See, e.g., Frank H. Easterbrook, *Limits of Antitrust*, 63 TEX. L. REV. 1 (1984) (arguing that over-enforcement is more dangerous than under-enforcement because under-enforcement is uniquely self-correcting through new entry); Lina M. Khan, *Amazon's Antitrust Paradox*, 126 YALE L. J. 710 (2016); Rohit Chopra & Lina M. Khan, *The Case for "Unfair Methods of Competition" Rulemaking*, 87 U. CHI. L. REV. 357 (2020); Lina M. Khan, *The Separation of Platforms and Commerce*, 119 COLUM. L. REV. 973 (2019).

¹⁴⁰ Douglas H. Ginsburg & Joshua D. Wright, *Dynamic Analysis and the Limits of Antitrust Institutions*, 78 ANTITRUST L.J. 1 (2012).

¹⁴¹ See, e.g., Kevin A. Bryan & Erik Hovenkamp, *Startup Acquisitions, Error Costs, and Antitrust Policy*, 87 U. CHI. L. REV. 331 (2020) ("a prominent feature of modern antitrust law [is] a strong preference for erring on the side of nonenforcement...plaintiffs generally face very demanding evidentiary requirements...").

¹⁴² See, e.g., Joshua D. Wright, *The Antitrust/Consumer Protection Paradox: Two Policies at War with Each Other*, 121 YALE L. J. 2216, 2219-20 (2011) (stating that the CFPB's role is to prevent unfair or abusive practices).

¹⁴³ Consumer Financial Protection Bureau, *Explore Interest Rates*, <https://www.consumerfinance.gov/owning-a-home/explore-rates/> [<https://perma.cc/9SV4-YDTH>].

¹⁴⁴ Joseph Bankman, *Tax Enforcement: Tax Shelters, the Cash Economy, and Compliance Costs* Woodworth Memorial Lecture, 31 OHIO N.U. L. REV. 1, 3,5 (2005) (criticizing "literalist" federal tax doctrines and praising "California's approach...[of] impos[ing] higher penalties on transactions that 'lack economic substance'").

IV. OBJECTIONS AND RESPONSES

In this section, we respond to potential critiques of our proposal.

A. Imperfect Calibration

Ideally, Pigouvian taxes should be set to equal the social harm caused by the externality-generating activity.¹⁴⁵ If the tax is set too high, it might suppress the activity to sub-optimal levels. If the tax is set too low, it will insufficiently discourage the activity. Thus, perfect calibration is optimal.

In the context of Pigouvian Contracts, the social harm is not only whatever costs are imposed on the subset of consumers who actually comprehend overly complex contracts, but also the harm from socially inefficient, one-sided terms, which survive in contracts because too few consumers actually read the fine print.¹⁴⁶ Admittedly, it is impossible to directly observe the costs of inefficient terms. Indeed, it is difficult to even identify inefficient terms in the absence of high levels of consumer comprehension. Instead, we rely on proxies based on the comprehension costs of the contract and the fraction of consumers who comprehend it.

As contracts get shorter and simpler, consumers will be able to understand more of the terms they encounter. Such scrutiny will restrict the use of inefficiently pro-seller terms. Moreover, we show that taxing sellers based on contractual complexity and subsidizing consumer comprehension and information-sharing would further limit the proliferation of inefficient terms.

Because regulators can adjust taxes and subsidies to target a particular level of consumer comprehension, it is not necessary for them to precisely calibrate the social harm. Indeed, economist William Baumol made an analogous argument fifty years ago.¹⁴⁷ Moreover, even an imperfectly calibrated Pigouvian tax will often be an improvement over the status quo ante.¹⁴⁸

A related objection is that there may be some “informed minority” that is more efficient than targeting complete, perfect comprehension by all consumers. The ideal level of consumer comprehension would depend on

¹⁴⁵ Victor Fleischer, *Curb Your Enthusiasm for Pigouvian Taxes*, 68 VAND. L. REV. 1673 (2015) (describing Pigouvian taxes in the context of carbon emissions).

¹⁴⁶ See Simkovic & Furth-Matzkin, *supra* note 1.

¹⁴⁷ Baumol, *supra* note 22, at 318.

¹⁴⁸ See, e.g., Galle, *supra* note 24; Gunnar S. Eskeland, 8 WORLD BANK ECON. REV. 373, 375-78 (1994); Baumol, *supra* note 22, at 314-316, 319-320.

hard-to-observe factors such as: (1) The distribution of inefficient contracts and what they cost socially; (2) The cost and efficacy of improving default rules; (3) The effects of comprehension levels on consumer behavior; (4) The effect of taxation on sellers' drafting decisions; (5) and whether consumer preferences are sufficiently uniform that an informed minority can protect non-reading consumers. Because each of these is difficult to observe, in practice, identifying the optimal comprehension level would be difficult.¹⁴⁹

However, we can conclude that ideal comprehension would almost certainly be higher than the status quo of almost none in many consumer markets.

B. Why Doesn't the Market Correct this Failure?

Businesses can solve many problems when there is a viable business model that enables the business to capture a sufficient amount of the value it creates. There are two types of businesses that could attempt to correct information problems in consumer contracts: intermediaries and competing businesses. But they are both unlikely to fully solve the problem without the policy changes we suggest.

1. Intermediaries

Intermediaries struggle to capture the benefits of generating and sharing information with consumers. Information is a classic example of a public good: It is non-rivalrous, and it is difficult to exclude free-riders from enjoying it.¹⁵⁰ We have previously noted many of the challenges that information intermediaries face.¹⁵¹ These challenges limit the quality and quantity of information intermediaries can provide. This, in turn, increases search costs for consumers and makes it difficult for them to determine the

¹⁴⁹ Previous studies considering "informed minority" theory have also generally not specified an optimal or sufficient consumer comprehension level. *See, e.g.,* Alan Schwartz & Louis Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 638, 655 (1979) (explaining the difficulty of obtaining an optimal efficient market information); Yannis Bakos, Florencia Marotta-Wurgler & David R. Trossen, *Does Anyone Read the Fine Print? Consumer Attention to Standard-Form Contracts*, 43 J. LEGAL STUD. 1, 27 (2014).

¹⁵⁰ Stiglitz, *supra* note 29, at 1448.

¹⁵¹ *See supra*, Section II. Pigouvian Contracts.

quality of the information they obtain.¹⁵²

Some scholars have argued that new technologies such as artificial intelligence, contract readers, and advisors may mitigate the problem of overwhelmed non-reading consumers.¹⁵³ Such readers, unless subsidized by governments, will need private funding, and so will either be costly to consumers, or risk bias in favor of sponsors.¹⁵⁴ Tools that purport to increase comprehension and save time, and which sellers commit to provide to consumers at no additional cost, could be tested in the contract evaluation process that sets the tax.

2. Competing businesses

Prominent scholars have argued that market competition will correct consumer errors.¹⁵⁵ This requires businesses to educate consumers about differences between contracts. Anecdotally, businesses occasionally advertise differences between their own contracts and those of competitors. For example, T-Mobile claimed to offer cell phone service with “no contract” (in reality, this was a shorter contract).¹⁵⁶ Southwest claimed not to charge extra “hidden fees” for checked bags and other services. Banks and internet providers advertised no fees for certain services.¹⁵⁷

Why then, does competition not solve the problem?

Because the strategy of “educating consumers” is costly.¹⁵⁸ It is only

¹⁵² George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

¹⁵³ Arbel & Becher, *supra* note 45; Van Loo, *supra* note 45.

¹⁵⁴ Simkovic & Furth-Matzkin, *supra* note 1; see Gerhard Wagner & Horst Eidenmuller, *Down by Algorithms?*, 86 U. Chi. L. Rev. 581 (2019) (discussing commercial efforts to steer customers toward sponsored products).

¹⁵⁵ Ronald H. Coase, *The Choice of the Institutional Framework: A Comment*, 17 J.L. & ECON. 493, 494–95 (1974) (expressing doubts that ignorance about inefficient policy terms will persist in a competitive insurance market); Lee Goldman, *My Way and the Highway: The Law and Economics of Choice of Forum Clauses in Consumer Form Contracts*, 86 NW. U. L. REV. 700, 716 (1992) (positing that “[i]f a seller includes unwanted terms in its contracts, a business offering the preferred higher price/easier terms option should inform consumers that although the competitor’s price is lower, the real value that the competitor offers is less”).

¹⁵⁶ Oren Bar-Gill & Omri Ben-Shahar, *Exit from Contract*, 6 J. LEGAL ANALYSIS 151, 153 (2014).

¹⁵⁷ BOB SULLIVAN, GOTCHA CAPITALISM: HOW HIDDEN FEES RIP YOU OFF EVERY DAY—AND WHAT YOU CAN DO ABOUT IT (2008).

¹⁵⁸ See, e.g., Bar-Gill, *supra* note 14; Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1206, 1255–56 (2003).

likely to succeed for a small number of terms that can inexpensively be rendered salient to consumers. For example, we do not typically see businesses advertising that they do not require arbitration or that they allow for trial by jury in case of a dispute.

Moreover, even if one business were to succeed in attracting consumers based on its higher quality contract terms, its strategy could be quickly copied by competitors.¹⁵⁹ The result is that the first mover would incur substantial costs educating the market but no long-term gains from increased market share.¹⁶⁰ Well-advised businesses generally avoid such errors of judgment.¹⁶¹ They typically refrain from informing consumers about their competitors' shortcomings.¹⁶²

Game theorists might describe sellers' decisions to refrain from educating consumers as decisions not to "defect" in a repeat-player game when the long-term payoff to cooperation with other sellers is higher.¹⁶³ Moreover, it should be noted that parallel action, without a collusive agreement, is typically not sanctionable as an anti-trust violation.¹⁶⁴

Our proposal would increase the amount of competition by making it less costly for a "defecting" seller to educate consumers about the advantages of its own contracts compared to competitors'. All contracts would be shorter and simpler, and the government would pay consumers to read them. The costs of education would no longer be borne entirely by the defecting seller.

¹⁵⁹ See, e.g., Bar-Gill, *supra* note 14.

¹⁶⁰ *Id.*

¹⁶¹ See, e.g., Sullivan, *supra* note 157 ("I know of no single agency or company devoted to stopping the explosion of hidden fees, which cost our society just as much as identity theft.").

¹⁶² See Michael E. Porter, *What is Strategy?* HARV. BUS. REV. (1996), <https://hbr.org/1996/11/what-is-strategy> [<https://perma.cc/PBK8-QAY2>] ("the heart of strategy is . . . [avoiding] mutually destructive competition . . . hypercompetition is a self-inflicted wound, not the inevitable outcome . . .").

¹⁶³ David G. Rand, Hisashi Ohtsuki & Martin A. Nowak, *Direct Reciprocity with Costly Punishment: Generous Tit-for-Tat Prevails*, 256 J. THEORETICAL BIOLOGY 45–57 (2009); John William Hatfield et al., *Collusion in Markets with Syndication*, 128 J. POL. ECON. 3779 (2020); Martin A. Nowak, *Evolutionary Game Theory*, 9 CURRENT BIOLOGY R503, R504 (1999).

¹⁶⁴ Michael K. Vaska, *Conscious Parallelism and Price Fixing: Defining the Boundary*, 52 U. CHI. L. REV. 508 (1985); Jonathan B. Baker, *Two Sherman Act Section 1 Dilemmas: Parallel Pricing, the Oligopoly Problem, and Contemporary Economic Theory*, 38 ANTITRUST BULL. 143–219 (1993); William E Kovacic et al., *Plus Factors and Agreement in Antitrust Law*, 110 MICH. L. REV. 44 (2011).

C. Isn't it Simpler and Better to Just Regulate Content?

Regulators and courts attempt to protect consumers from exploitative practices by banning certain terms or by refusing to enforce “unconscionable” provisions.¹⁶⁵ Yet, because of limited information and resources, regulators and courts inevitably make errors and act slowly.¹⁶⁶

If regulators and courts ban only the most egregious terms, which are highly likely to be inefficient,¹⁶⁷ then inefficient terms might persist even with regulatory oversight. Our proposal would supplement regulation by enlisting market forces to limit inefficient terms. In addition, sellers’ voluntary simplification of their contracts to reduce tax liability would conserve regulatory resources. Finally, increased consumer comprehension could translate not only into market behavior, but also into political action.

D. Consumers will not Read Anyway

Reading contracts can be unpleasant.¹⁶⁸ Economists refer to psychic pain as “hedonic costs” imposed on readers.¹⁶⁹ Taxing sellers based on the attention costs their contracts impose would likely lead to shorter, simpler contracts. However, collective action problems among consumers might still limit consumer comprehension. If each consumer hopes that others will read and negotiate, consumers may free-ride on others’ efforts. Consequently, there will not be enough readers to generate competition on terms.

This raises the question: will consumers read contracts if they are short and simple? Empirical evidence suggests yes.¹⁷⁰

¹⁶⁵ Richard Epstein, *Unconscionability: A Critical Reappraisal*, 18 J.L. & ECON. 293, 294 (1975); John A. Spanogle, Jr., *Analyzing Unconscionability Problems*, 117 U. PA. L. REV. 931 (1969).

¹⁶⁶ Zamir & Ayres, *supra* note 17.

¹⁶⁷ Ryan Bubb & Richard H. Pildes, *How Behavioral Economics Trims Its Sails and Why*, 127 HARV. L. REV. 1593 (2014) (discussing policy preferences for nudges over more aggressive but potentially more effective substantive interventions).

¹⁶⁸ RICHARD A. EPSTEIN, CONSUMER PROTECTION IN THE AGE OF THE “INFORMATION ECONOMY” 227 (Jane K. Winn ed., 2006); Michael Simkovic & Frank McIntyre, *The Economic Value of a Law Degree*, 43 J. LEGAL STUD. 249 (2014).

¹⁶⁹ Cass R. Sunstein, *Ruining Popcorn? The Welfare Effects of Information*, 58 J. RISK & UNCERTAINTY 121 (2019); CASS R. SUNSTEIN, *TOO MUCH INFORMATION: UNDERSTANDING WHAT YOU DON'T WANT TO KNOW*, MIT Press, 2020.

¹⁷⁰ Saurabh Bhargava & George Loewenstein, *Behavioral Economics and Public Policy 102: Beyond Nudging*, 105 AM. ECON. REV. 396 (2015); Cass R. Sunstein, *Empirically Informed Regulation*, 78 U. CHI. L. REV. 1349 (2011); GENEVIÈVE HELLERINGER, *NUDGING-*

Moreover, when simpler contracts improve consumer comprehension, consumers behave differently. For example, the introduction of a standardized interest rate, the APR, has made it easier for consumers to comparison-shop for credit.¹⁷¹ Studies suggest that additional simplifications can further improve consumer understanding.¹⁷²

Our proposal not only encourages sellers to simplify contracts, but also uses subsidies to encourage consumers to try harder to understand them. Even if there are hedonic costs to reading, there is some price at which consumers would bear them or pay an advisor to assist them.¹⁷³

Collective action problems that lead to non-readership could be mitigated by compensating consumers who choose to read the contract and can demonstrate comprehension. Compensation could be paid only to those who post an online review of the contract or share information with others. Just as sellers rely on lawyers to scrutinize contracts, this subsidy would increase the chances that at least some consumers scrutinize contracts. Compensation would reward readers for the positive externalities they generate

One concern is that compensating readers could incentivize some consumers with ample free time to read excessively without intent to transact. Sellers must pay a tax each time they present a contract to consumers. Thus, compensating consumers increases the burden on sellers to distinguish good-faith customers from opportunistic readers. But sellers already have incentives to avoid customers who waste salespeople's time without buying.¹⁷⁴ In addition, some initially disinterested readers, after

POSSIBILITIES, LIMITATIONS AND APPLICATIONS IN EUROPEAN LAW AND ECONOMICS 153-167 (Klaus Mathis et al. eds., 2016); George Loewenstein, Cass R. Sunstein, & Russell

Golman, *Disclosure: Psychology Changes Everything*, 6 ANN. REV. ECON. 391, 396 (2014).

¹⁷¹ Jinkook Lee & Jeanne M. Hogarth, *The Price of Money: Consumers' Understanding of APRs and Contract Interest Rates*, 18 J. PUB. POL'Y & MKTG. 66 (1999).

¹⁷² BAR-GILL, SEDUCTION BY CONTRACT, *supra* note 14 at 125–26; George Loewenstein, et. al., *supra* note 170; Sumit Agarwal et al., *Do Consumers Choose the Right Credit Contracts?*, 4 REV. CORP. FIN. STUD. 239–257 (2015); Alycia Chin & Wändi Bruine de Bruin, *Helping Consumers to Evaluate Annual Percentage Rates (APR) on Credit Cards*, 25 J. EXPERIMENTAL PSYCH: APPLIED 77–87 (2019); Oren Bar-Gill & Alma Cohen, *How to Communicate the Nudge: A Real-World Policy Experiment*, 65 J.L. & Econ. 607 (2022) (showing that simplified disclosures, especially those communicated through text messages, shape debtors' behavior); Shannon White, WHEN SHROUDED PRICES SIGNAL TRANSPARENCY: CONSEQUENCES OF PRICE DISAGGREGATION 7 (2020).

¹⁷³ See, e.g., Gary Charness et. al., *Experimental Methods: Measuring Effort in Economics Experiments*, 149 J. ECON. BEHAV. & ORG. 74 (2018) (discussing the use of incentives to encourage greater effort by subjects in economics experiments).

¹⁷⁴ If the problem of opportunistic readership proves to be significant, it could be addressed by reducing the subsidy.

interacting with sellers, may decide to buy.

E. Consumers' Heterogenous Preferences

Our solution relies on comprehending consumers improving contracts for *all* consumers, including those who do not comprehend. But if consumers who comprehend have different preferences, sellers might change their contracts to suit only comprehending consumers without sufficiently benefitting non-comprehending consumers.

However, our approach gives sellers incentives to segment the market by comprehension abilities and preferences. The more consumers who cannot understand the contract, the higher the tax would be because these consumers would need a lawyer to explain the contract to them. Sellers could reduce the tax by creating simpler contracts for such consumers. The higher the minimum percent of consumers that must comprehend the contract, the stronger sellers' incentives to segment the market.

F. Monopolistic Sellers will not Improve their Contracts

Another objection is that seller monopoly limits the advantages of contract simplification and consumer comprehension. We argue that even under monopoly conditions, simplification and comprehension would still create value.

If a seller has complete monopoly power—for example if a cable company is the only provider of high-speed internet in a remote area—then the monopolistic seller will face less pressure to improve its contracts. Consumers may be able to read and understand contracts, but this will do them little good because there is no market alternative. Moreover, the monopolist's product may be a quasi-necessity (i.e., demand for that product may be highly inelastic).¹⁷⁵

However, even a monopolist faces a consumer demand curve. If consumers understand the monopolist's contract, then the monopolist can more easily capture more of the surplus from introducing better contract terms while increasing its prices.¹⁷⁶

¹⁷⁵ See, e.g., Rajeev K. Goel et al., *Demand Elasticities for Internet Services*, 38 APPLIED ECON. 975 (2006).

¹⁷⁶ William James Adams & Janet L. Yellen, *Commodity Bundling and the Burden of Monopoly*, 90 Q. J. ECON. 475 (1976); Michael Spence, *Product Selection, Fixed Costs, and Monopolistic Competition*, 43 REV. ECON. STUD. 217 (1976).

G. Too Costly to Administer

Another critique is that taxation and subsidization would be costly. If it is extremely costly, then costs could outweigh benefits. However, we argue that the costs would likely be small compared to the benefits, just as the costs to businesses from drafting form contracts are small compared to the aggregate benefits those businesses derive from such contracts.

1. Overview of administrative costs

First, regulators would have to design comprehension tests to use with consumers. Second, regulators would need to gather and pay survey participants. Third, regulators would need to estimate the financial costs of adequate comprehension based on consumer hourly earnings and attorneys' fees. Fourth, there would likely be an iterative process as sellers seek to improve their contracts and ask regulators to resurvey consumers to test improved versions. Fifth, regulators would need to ensure compliance through audits and enforcement actions. Sixth, more resources would be invested by sellers and consumers in drafting default rules. Seventh, subsidizing consumer compensation would also entail administrative costs.

Many of these costs will be low *per transaction*. Sellers typically use standard form contracts—either drafted in-house or taken off-the-shelf from a third-party provider—across many consumers.¹⁷⁷ Thanks to these economies of scale, regulators would only need to evaluate a relatively small number of contracts. Because regulators would take advantage of the same economies of scale that sellers use, administrative costs would be low relative to the aggregate value of consumer transactions. Regulators could also minimize costs by pricing based on relatively small but representative groups of test-consumers.

2. Contract evaluation costs

A significant cost will be incurred when the regulator evaluates each contract to set the tax. Back-of-the-envelope calculations suggest that the evaluation costs per form contract would likely range between \$40,000 to

¹⁷⁷ See, e.g., Robert A. Hillman & Jeffrey J. Rachlinski, *Standard-Form Contracting in the Electronic Age*, 77 N.Y.U. L. REV. 429 (2002).

\$100,000.¹⁷⁸ If a form contract is signed by one million consumers, the evaluation costs would equal 4 to 10 cents per customer.¹⁷⁹ To put this into context, Blumberg sells New York apartment lease forms for \$1.05 per form.¹⁸⁰ Legal Zoom sells residential lease forms for \$29.¹⁸¹ Thus, contract evaluations costs are low compared to the value of form contracts.

The initial contract evaluation cost would be negligible compared to the value of supported consumer transactions and the tax revenue. Even small businesses can use widely available form contracts. Contract publishers would recoup evaluation costs by increasing the price by a few cents. Businesses can also rely on informal understandings with their customers rather than taxable contracts.¹⁸²

3. Funding contract evaluation

The cost of evaluating contracts could either be: (1) charged to sellers; (2) provided free at the point of service and recouped through subsequent taxation of approved contracts; or (3) through an intermediate option under which sellers would pay fees that cover a portion of the contract evaluation cost. Remaining costs would be recouped through taxation of presentations of contracts to consumers.

User fees would discourage sellers from using unique contracts when stakes are low, and a novel contract is not worth consumers' time. On the other hand, subsidizing evaluation would encourage contractual innovation.

4. Enforcement costs

Compliance could be ensured through random auditing, third-party reporting, and private lawsuits, as noted above in Section III.B. The contract

¹⁷⁸ This figure assumes that comprehension requires two hours of a consumer's time at \$40 per hour, and that 100 consumers are included in the sample. This totals to \$8,000. We also assume 50 hours of attorney time at \$200 per hour to explain the contract to the attorney-assisted group. This increases costs by \$10,000 to total \$18,000. There would be some additional costs for recruiting subjects, physical space, IT, and to develop and score comprehension tests. In addition, sellers may revise and retest versions of their contracts to reduce the tax.

¹⁷⁹ Indeed, evaluating even a small niche form contract used for only 10,000 consumers would likely add at most \$10 in cost per consumer.

¹⁸⁰ Blumberg Lease, https://www.blumberg.com/invoice.cgi?rm=view_cluster;cluster_id=1762952 [<https://perma.cc/A9V8-V4DT>] (last accessed June 22, 2021).

¹⁸¹ Legal Zoom Lease, <https://www.legalzoom.com/personal/real-estate/residential-lease-pricing.html> [<https://perma.cc/MS6B-PCUZ>] (last accessed June 22, 2021).

¹⁸² Shmuel I. Becher & Tal Z. Zarsky, *Minding the Gap*, 51 CT. L. REV. 69 (2019).

tax would likely be easier to administer than the Federal Income Tax, especially after accounting for positive information spillovers which would make it easier to enforce *other* pre-existing taxes. The Federal Income Tax collects nearly \$100 for every 50 cents the IRS spends.¹⁸³

5. Default drafting costs

Default rules would likely be more widely used under our proposal because taxing contracts makes deviating from defaults more expensive.¹⁸⁴ Sellers, consumer representatives, and regulators would therefore invest in improving default rules, at some cost. But total drafting costs could *decline* through economies of scale and greater standardization. If drafted through a political process, defaults could reduce sellers' drafting costs and decrease variation across sellers in wording of functionally identical terms.¹⁸⁵

Just as form contracts reduce costs to sellers by standardizing terms across transactions,¹⁸⁶ widely used default rules could reduce costs by standardizing terms across an even broader group of transactions and sellers.¹⁸⁷ As consumers become familiar with more uniform terms,¹⁸⁸ they will be able to focus their attention on other attributes of goods or services. Consequently, market competition on these other attributes will increase.

Increased standardization under our proposal is likely to be closer to optimal than the status quo. This is because the optimal level of variation cannot be inferred from market practice in the presence of attention externalities.¹⁸⁹ From the perspective of sophisticated businesses, the proliferation of complex, highly varied contractual terms can be profit-maximizing to the firm—but not necessarily socially efficient—because higher search costs that overwhelm consumers reduce competition and facilitate oligopolistic pricing.

Excessive customization can contribute to widespread uncertainty as

¹⁸³ Internal Revenue Service, Internal Revenue Service Data Book, 66 tbl.29 (2008).

¹⁸⁴ See, e.g., Margaret Jane Radin, *Boilerplate Today: The Rise of Modularity and the Waning of Consent*, 104 Mich. L. Rev. 1223, 1224 (2006).

¹⁸⁵ Simkovic & Furth-Matzkin, *supra* note 1.

¹⁸⁶ See, e.g., HENRY BUTLER ET AL., *ECONOMIC ANALYSIS FOR LAWYERS* 183 (3d ed. 2015); Randy E. Barnett, *Consenting to Form Contracts*, 71 *FORDHAM L. REV.* 627, 630–31 (2002); Robert A. Hillman, *Rolling Contracts*, 71 *FORDHAM L. REV.* 743, 747 (2002); RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 115 (6th ed. 2003).

¹⁸⁷ See, e.g., Radin, *supra* note 184, at 1224; RICHARD BERNER & KATHRYN JUDGE, *SYSTEMIC RISK IN THE FINANCIAL SECTOR*, (Douglas W. Arner et al. eds., 2019).

¹⁸⁸ See, e.g., Ayres & Schwartz, *supra* note 6.

¹⁸⁹ See, e.g., Julie E. Cohen, *The Regulatory State in the Information Age*, 17 *THEORETICAL INQUIRIES L.* 369 (2016) (discussing problems from 'infoglut' and excessive disclosures).

multiple versions of the same term proliferate. Case law clarifying the meaning of one version of these terms can cast doubt on the meaning of all other variations.¹⁹⁰ Standardization increases the efficiency of case law in clarifying the meaning of these terms.

If contractual variation is valuable, for example, because consumers have heterogeneous preferences, sellers can offer a menu of contracts by opting out of the defaults.¹⁹¹ This preserves freedom of contract; sellers need only internalize the attention externalities they generate.

H. Complex Contracts Create Value

Another objection is that contractual complexity is valuable because it enables contracts to be more sensitive to specific contexts. A tax on contracts would lead to shorter contracts, potentially reducing some of this value.

However, as explained in Section II, **Error! Reference source not found.** *Pigouvian Contracts* pairs a tax on presentation of a seller's contract with a subsidy for consumers who read contracts. This pairing effectively taxes *inefficient* contracts more heavily than *efficient* contracts. The reason for this is that when a seller's contract is inefficient, comprehending consumers will not transact. But when a seller's contract is efficient, consumers transact. Thus, a seller with an efficient contract can raise its prices to capture the consumer subsidy. This subsidy effectively cancels out the tax. By contrast, a seller with an inefficient contract cannot capture the consumer subsidy by raising prices, because the consumers who read pocket the subsidy and then decline to transact. In sum, sellers with inefficient contracts and consumers who do not read bear most of the tax burden, while sellers with efficient contracts and consumers who read are taxed more lightly, if at all.

Nevertheless, there may be some *marginally* efficient complex contracts that will be taxed out of use. Contracts that provide more value will persist. The benefits of marginally efficient but complex contracts could be preserved if their provisions were adopted as defaults.¹⁹²

Some have argued that defaults are not context-sensitive.¹⁹³ But they

¹⁹⁰ Robert K Rasmussen & Michael Simkovic, *Bounties for Errors: Market Testing Contracts*, 10 HARV. BUS. L. REV. 117 (2020); Stephen J. Choi et al., *Variation in Boilerplate: Rational Design or Random Mutation?*, 20 AM. L. & ECON. REV. (2018).

¹⁹¹ See, e.g., Zamir & Ayres, *supra* note 17, at 319.

¹⁹² Simkovic & Furth-Matzkin, *supra* note 1.

¹⁹³ Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779 (2011).

*can be.*¹⁹⁴ For example, if two investors form a non-Delaware partnership under the Uniform Partnership Act without specifying how much each owns, they each own half by default.¹⁹⁵ However, if two investors form a Delaware limited liability company or a corporation without specifying ownership, then by default, governance rights are shared in proportion to their capital contributions.¹⁹⁶ In fact, even in the context of mandates, there is considerably more context-specificity than has traditionally been assumed.¹⁹⁷ For example, the 2009 Card Act, which bans certain methods of calculating interest payments in credit card contracts,¹⁹⁸ does not ban these methods in other types of credit products, like commercial revolving credit facilities or mortgages.¹⁹⁹

I. Defaults could still be Anti-Consumer

Sellers may find it easier than consumers to organize politically to influence the default drafting process because sellers are fewer in number and more focused on their business. However, political processes generally tend toward efficient policies because welfare gains can buy off the opposition.²⁰⁰ Moreover, consumers may have more representation than market clout because the political system offers more avenues for collective action.²⁰¹ Thus, although defaults are likely to be pro-business, they may be less one-sided than sellers' unilaterally drafted contracts.

¹⁹⁴ For similar observations, see Ian Ayres, *Regulating Opt-Out: An Economic Theory of Altering Rules*, 121 *YALE L.J.* 2032, 2084-96 (2012); Eyal Zamir, *The Inverted Hierarchy of Contract Interpretation and Supplementation*, 97 *COLUM. L. REV.* 1710, 1738-53, 1758-65; Ariel Porat & Lior Jacob Strahilevitz, *Personalized Default Rules and Disclosure with Big Data*, 112 *MICH. L. REV.* 1417 (2014); Anthony J. Casey & Anthony Niblett, *The Death of Rules and Standards*, 92 *IND. L.J.* 1401 (2017).

¹⁹⁵ UPA (1997) § 401 Partners rights and duties.

¹⁹⁶ Delaware Code § 18-402 Management of limited liability company.

¹⁹⁷ See Zamir & Ayres, *supra* note 17 at 287.

¹⁹⁸ Simkovic, *supra* note 1 (summarizing the CARD Act).

¹⁹⁹ Simkovic, *supra* note 1; Bar-Gill, *supra* note 14; Susan Block-Lieb & Edward J. Janger, *The Myth of the Rational Borrower: Rationality, Behaviorism, and the Misguided 'Reform' of Bankruptcy Law*, 84 *TEX. L. REV.* 1481-1565 (2006); CAROLYN B. MOLONEY & CHARLES E. SCHUMER, *Vicious Cycle: How Unfair Credit Card Practices Are Squeezing Consumers and Undermining the Recovery* (2009).

²⁰⁰ Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 *Q. J. ECON.* 371-400 (1983).

²⁰¹ GUNNAR TRUMBULL, *STRENGTH IN NUMBERS: THE POLITICAL POWER OF WEAK INTERESTS* at 119 (2012) (discussing the ability of consumers, small businesses and other diffuse interests to influence public policy); STEVEN P. CROLEY, *REGULATION AND PUBLIC INTERESTS: THE POSSIBILITY OF GOOD REGULATORY GOVERNMENT* (2008).

J. Consumers Learn about Contracts without Reading

Another objection is that consumers can learn about the implications of contracts without actually reading the contracts. They can do so, for example, by reading summaries or reviews of the contracts, or by gaining experience in dealing with a particular seller.²⁰² As noted above, learning from such sources still imposes costs on consumers. If sellers wish to argue for a lower tax because consumers can learn more cheaply through these sources than through reading, then sellers may include summaries or reviews in disclosures integrated into their contracts when they submit their contracts for evaluation.

K. Consumers will Need to Learn about Defaults

Another objection is that greater reliance on default rules may place higher burdens on consumers to become informed of the default rules. Although default rules may be simpler and more standardized than form contracts, some research may still be required to learn these rules. This research can be facilitated by third parties such as non-profits or government agencies, which can provide simple comprehensible summaries of default rules, as many now do for tenants' rights, air passengers rights, and other issues.²⁰³ Sellers may also provide links to relevant default rules. These links to or restatements of default rules could be exempt from taxation. While some consumers may only learn about defaults after an issue arises, consumers will likely become familiar with defaults over time because the rules would likely change slowly. Consumers will therefore be more attuned to deviations from those rules. Once consumers become informed about the defaults, this knowledge can be used across transactions with different sellers. Note, however, that even consumers who are not aware of default rules would typically benefit from our proposal because the contracts they enter into are likely to be more consumer-friendly than sellers' unilaterally drafted contracts.

²⁰² See Arbel *supra* note 45; see also Bar-Gill, *supra* note 14.

²⁰³ For example, the U.S. Dep't of Hous. and Urban Dev., and many local governments, post information online about tenants' rights. See e.g., U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, TENANT RIGHTS, LAWS AND PROTECTIONS: CALIFORNIA, <https://www.hud.gov/states/california/renting/tenantrights> [<https://perma.cc/3UPJ-ZBWZ>].

L. Sellers will Increase Prices

Sellers who use efficient contracts can respond to a tax on contracts by increasing prices. If sellers raise prices by just enough to pay the tax, and consumers receive a subsidy for reading contracts, then the tax and subsidy will affect a payment from non-reading to reading consumers. This would compensate readers for the value they create by improving contract quality.²⁰⁴

However, in most markets, which are not perfectly competitive, some of these costs could be absorbed by sellers without a price increase. This is because in non-competitive markets, sellers price their products or services according to consumers' willingness to pay, rather than marginal production costs, resulting in supra-competitive profits (or "rents").

M. Other Solutions

Courts, legislatures, and scholars have all previously considered the problem of consumer non-readership.²⁰⁵ They have proposed solutions, including heightened judicial scrutiny, mandatory substantive regulation, anti-fraud statutes, disclosures,²⁰⁶ readability reforms, a warning box for unexpectedly bad terms,²⁰⁷ regulatory pre-approval of contracts,²⁰⁸ and the reasonable expectations doctrine.

Our approach is compatible with these solutions.²⁰⁹ For example, it can operate with many or few mandatory terms. The market check provided by informed consumer choice can help policymakers determine the most efficient mandatory terms, thereby improving substantive regulation. In

²⁰⁴ See, e.g., Richard Craswell, *Passing on the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships*, 43 STAN. L. REV. 361, 362, 368-85 (1991) (discussing the ability to passthrough the costs of a regulation directly imposed on one party to another party); Henry E. Smith, *Ambiguous Quality Changes from Taxes and Legal Rules*, 67 U. CHI. L. REV. 647, 648 (2000) (discussing how quality can improve in response to legal rules).

²⁰⁵ See Bakos et al., *supra* note 5, at 2.

²⁰⁶ George Loewenstein, Cass R. Sunstein & Russell Golman, *Disclosure: Psychology Changes Everything*, 6.1 ANN. REV. ECON. 391 (2014); Ryan Bubb, *TMI: Why the Optimal Architecture of Disclosure Remains TBD*, 113 MICH. L. REV. 1021 (2014).

²⁰⁷ Ayres & Schwartz, *supra* note 6.

²⁰⁸ Clayton P. Gillette, *Pre-Approved Contracts for Internet Commerce*, 42 HOUS. L. REV. 975 (2005); Eric Posner & E. Glen Weyl, *An FDA for Financial Innovation: Applying the Insurable Interest Doctrine to Twenty-First-Century Financial Markets*, 107 NW. U. L. REV. 1307 (2013).

²⁰⁹ Simkovic & Furth-Matzkin, *supra* note 1.

addition, market competition will lead to more consumer-friendly terms even when regulators act slowly.

Some might argue that existing solutions are better than our proposal. This critique should only raise doubts about the desirability of our proposal if existing solutions completely solve the problem so that our solution could make no marginal contribution.

V. CONCLUSION

Markets for contract terms do not work because it typically does not make sense for consumers to become informed about contractual terms. This drives sellers to adopt inefficient contracts. This problem is extremely difficult to solve because sellers and regulators cannot discern consumers' preferences if consumers do not understand contracts. Nor do regulators know how complicated a contract should be given the value at stake for the consumer.

We propose to tax sellers who present contracts to consumers in proportion to what it would cost consumers to understand these contracts. We also propose subsidizing consumer comprehension. Making sellers internalize these costs would incentivize them to conserve consumer attention and only use contracts when enough value is at stake. We propose mechanisms to estimate the comprehension costs that sellers' contracts impose on consumers and charge these costs back to sellers.

A major advantage of our proposal is that it requires relatively little regulatory expertise or knowledge about the optimal complexity of sellers' contracts. Our approach also permits sellers to customize contracts while setting background conditions so that markets channel innovations in a pro-social direction.

Making sellers internalize comprehension costs and subsidizing consumer comprehension creates a competitive market for contract terms. In this market, sellers will draft contracts that are at the optimal level of complexity, given the stakes to consumers. As more consumers comprehend contracts, sellers will learn which terms appeal to consumers and will improve their contracts accordingly. Inefficient contracts will be driven out of the market. Only contractual innovations that improve upon default terms for *both* sellers and consumers will survive.