Game Theory and the Structure of Administrative Law

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How should administrative agencies choose among the different policy-making instruments at their disposal? Although the administrative law literature has explored this question with respect to the instruments of adjudication and rule making, it has failed to appreciate two other powerful instruments at agencies' disposal: advance ruling and licensing. Taking these four policy-making instruments into consideration, this Article provides a general theory to guide agencies in selecting the most suitable policy-making instrument in different policy environments. To do so, the Article utilizes a new game-theoretic framework, focusing on two central dimensions of policy-making instruments in particular: timing and breadth. This framework provides two valuable implications. First, it highlights two key administrative challenges that are underappreciated by the academic literature: the holdup and leniency problems. And second, the framework shows that administrative agencies are underutilizing two powerful policy-making instruments, namely, licensing and advanced rulings. I argue that these two instruments are valuable across areas of law.

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INTRODUCTION

Administrative agencies must regularly draw lines to distinguish between firms that do and do not receive favorable treatment under legal and administrative standards.[1] Agencies may use different policy-making instruments to clarify these lines and resolve borderline cases.

Administrative agencies may issue rules, clarifying which cases in the legally gray area are entitled to the favorable legal treatment and which are not. Alternatively, they may wait for firms to act, and then rely on case-by-case adjudication to determine which cases are entitled to the favorable legal treatment. A third possibility is for administrative agencies to supplement case-by-case adjudication with advance ruling. This offers firms the opportunity to ask agencies, before they act, whether their action is entitled to the favorable legal treatment. Finally, agencies may require firms to preapprove their action in order to be entitled to the favorable legal treatment.

Administrative agencies may therefore employ four basic policy-making instruments: rule making, adjudication, advance

[1] See, for example, David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 Cornell L Rev 1627, 1627, 1632 (1999).

ruling, and licensing.[2] The administrative law literature has devoted much attention to the choice between rule making and adjudication.[3] However, it has ignored the policy-making instruments of advance ruling and licensing.[4] Thus, this Article is the first to consider the policy-making instruments of advance ruling and licensing and to provide a comprehensive analysis of administrative agencies' choice among these four policy-making instruments.

That administrative agencies actually utilize these four instruments in different contexts can be demonstrated by looking across areas of law and within areas of law. First, let us look across areas of law. Many administrative law scholars have famously noted that while the National Labor Relations Board (NLRB) relies heavily on adjudications (despite having the authority to issue rules),[5] the Federal Communications Commission (FCC) relies heavily on rule making.[6] However, licensing is also used as a policy-making instrument in different contexts. For example, to determine whether there is substantial evidence that a drug will have the effect it purports to have, the Food and

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[2] Under the Administrative Procedure Act both advance ruling and licensing are considered adjudication. 5 USC § 551(5)–(9). In this Article, however, I treat ex post adjudication separately from advance ruling and licensing, as they differ in several important respects.

[3] See, for example, Warren E. Baker, *Policy by Rule or Ad Hoc Approach—Which Should It Be?*, 22 L & Contemp Probs 658, 660–65 (1957); James M. Landis, *Report on Regulatory Agencies to the President-Elect* 18, 22 (Government Printing Office 1960); Cornelius J. Peck, *The Atrophied Rule-Making Powers of the National Labor Relations Board*, 70 Yale L J 729, 755–61 (1961); Henry J. Friendly, *The Federal Administrative Agencies: The Need for Better Definition of Standards* 142–47 (Harvard 1962); David L. Shapiro, *The Choice of Rulemaking or Adjudication in the Development of Administrative Policy*, 78 Harv L Rev 921, 929–58 (1965); Ralph F. Fuchs, *Agency Development of Policy through Rule-Making*, 59 Nw U L Rev 781, 789–95 (1965); Kenneth Culp Davis, *Discretionary Justice: A Preliminary Inquiry* 65–68 (Louisiana State 1969); Merton C. Bernstein, *The NLRB's Adjudication-Rule Making Dilemma under the Administrative Procedure Act*, 79 Yale L J 571, 587–93 (1970); Glen O. Robinson, *The Making of Administrative Policy: Another Look at Rulemaking and Adjudication and Administrative Procedure Reform*, 118 U Pa L Rev 485, 513–28 (1970); Antonin Scalia, *Back to Basics: Making Law without Making Rules*, 5 Regulation 25, 25–28 (July/Aug 1981); Colin S. Diver, *Policymaking Paradigms in Administrative Law*, 95 Harv L Rev 393, 428–34 (1981); M. Elizabeth Magill, *Agency Choice of Policymaking Form*, 71 U Chi L Rev 1383, 1444–47 (2004).

[4] Shapiro, 78 Harv L Rev at 923 (cited in note 3), mentions advance rulings, but only in passing.

[5] See Mark H. Grunewald, *The NLRB's First Rulemaking: An Exercise in Pragmatism*, 41 Duke L J 274, 274 (1991); Peck, 70 Yale L J at 730 (cited in note 3).

[6] See Robinson, 118 U Pa L Rev at 531–32 (cited in note 3); Jonathan Blake, *The "Vast Wasteland" Speech Revisited*, 55 Fed Commun L J 459, 462 (2003).

Drug Administration (FDA) requires new drugs to be individually approved before they can be sold.[7] To determine which buildings are legal, individual building permits have to be obtained before construction is commenced.[8] And to determine which research project that involves human subjects is legal, individual applications have to be approved by institutional review boards before research is conducted.[9] Similarly, advance ruling is used as a policy-making instrument by several administrative agencies. The Internal Revenue Service (IRS) issues Private Letter Rulings,[10] the Securities and Exchange Commission (SEC) issues No-Action Letters,[11] the Occupational Safety and Health Administration (OSHA) issues Standard Interpretation Letters,[12] and the Department of Justice Antitrust Division issues Business Review Letters.[13]

Administrative agencies' choice of policy-making instrument can also be illustrated by looking within one specific area of law—tax law.[14] To determine when an investment in a foreign corporation is used to artificially defer tax payments, tax authorities[15] rely heavily on rule making as a policy-making instrument, issuing complex rules that define which taxpayers must include in their income specific amounts earned by foreign corporations.[16] To determine which transactions lack economic substance and therefore are not recognized for tax purposes, tax authorities avoid issuing rules or other sorts of guidance, relying

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7 21 USC § 355.

8 See, for example, the requirements for obtaining a building permit in the city of Boston. City of Boston, *Building Division*, online at http://www.cityofboston.gov/isd/building (visited May 21, 2014).

9 42 USC § 289a-1(A); 45 CFR § 46.

10 26 CFR § 601.201.

11 17 CFR § 140.99.

12 See, for example, Occupational Health & Safety Administration, *Re: Fall Protection/Use of Barricades; 1926.500, Subpart M* (May 12, 2000), online at https://www.osha.gov/pls/oshaweb/owadisp.show_document?p_table=INTERPRETATIONS&p_id=24802 (visited May 21, 2014) (describing fall-protection requirements under 29 CFR § 1926.500).

13 28 CFR § 50.6.

14 This may seem an unusual choice, as administrative lawyers rarely engage with the administrative aspects of tax law. However, by using tax law to illustrate general administrative law issues I wish to lend support to the position that rejects "tax exceptionalism" in administrative law, a position that was recently adopted by the Supreme Court in *Mayo Foundation for Medical Education and Research v United States*, 131 S Ct 704, 713 (2011).

15 I use this term to refer to the IRS, the Treasury, and Congress acting in the area of tax law.

16 26 USC §§ 951–65 and the respective regulations.

instead solely on adjudication as a policy-making instrument.[17] To determine which distributions of stock qualify as a tax-free spin-off, tax authorities employ advance ruling as a policy-making instrument, allowing corporations to request a private-letter ruling on the tax consequences of a spin-off.[18] Finally, to determine which organizations are engaged in charitable activities and are therefore entitled to a tax exemption, tax authorities rely on licensing as a policy-making instrument, requiring the majority of such organizations to first apply for recognition of their tax-exempt status before they can benefit from this tax exemption.[19]

How should administrative agencies choose among the four basic policy-making instruments available to them? To address this fundamental question I use a new game-theoretic framework, which focuses on the strategic interaction between administrative agencies and firms, an issue that has been ignored by the existing administrative law literature.[20] The application of game theory to administrative agencies has a long history in legal scholarship,[21] but little work has appreciated its implications

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17 See *Interim Guidance under the Codification of the Economic Substance Doctrine and Related Provisions in the Health Care and Education Reconciliation Act of 2010*, Notice 2010-62, 2010-40 Int Rev Bull 411, 412 (Oct 4, 2010). The economic-substance rule is found in 26 USC § 7701(o).

18 Treas Reg § 601.201(a)(2). See also Rev Proc 2012-1, 2012-1 Int Rev Bull. An expedited advance-ruling process may be requested for a corporate spin-off advance ruling. See Rev Proc 2012-1, 2012-1 Int Rev Bull § 7.02(4)(a).

19 26 USC § 508(a); Treas Reg § 1.508-1(a).

20 For an analysis of the strategic interaction between administrative agencies and firms in the context of judicial deference to agencies' statutory interpretation, see generally Yehonatan Givati, *Strategic Statutory Interpretation by Administrative Agencies*, 12 Am L & Econ Rev 95 (2010).

21 See generally, for example, Peter H. Aranson, Ernest Gellhorn, and Glen O. Robinson, *A Theory of Legislative Delegation*, 68 Cornell L Rev 1 (1982); Jonathan R. Macey, *Separated Powers and Positive Political Theory: The Tug of War over Administrative Agencies*, 80 Georgetown L J 671 (1992); Daniel B. Rodriguez, *The Positive Political Dimensions of Regulatory Reform*, 72 Wash U L Q 1 (1994); Linda R. Cohen and Matthew L. Spitzer, *Judicial Deference to Agency Action: A Rational Choice Theory and an Empirical Test*, 68 S Cal L Rev 431 (1996); David B. Spence and Frank Cross, *A Public Choice Case for the Administrative State*, 89 Georgetown L J 97 (2000); Eric A. Posner, *Controlling Agencies with Cost-Benefit Analysis: A Positive Political Theory Perspective*, 68 U Chi L Rev 1137 (2001); Jason Scott Johnston, *A Game Theoretic Analysis of Alternative Institutions for Regulatory Cost-Benefit Analysis*, 150 U Pa L Rev 1343 (2002); Matthew C. Stephenson, *Legislative Allocation of Delegated Power: Uncertainty, Risk, and the Choice between Agencies and Courts*, 119 Harv L Rev 1035 (2006); Matthew C. Stephenson, *The Strategic Substitution Effect: Textual Plausibility, Procedural Formality, and Judicial Review of Agency Statutory Interpretations*, 120 Harv L Rev 528 (2006); Matthew C. Stephenson, *Optimal Political Control of the Bureaucracy*, 107 Mich L Rev 53

for the selection of policy-making instruments by administrative agencies.[22]

In Part I, I begin by laying out the game-theoretic framework.[23] The central problem administrative agencies face when choosing among policy-making instruments is the agencies' uncertainty as to the desired policy. Agencies lack information on firm-specific circumstances, and therefore they are uncertain how firms will react to possible policies. To illustrate, because the US Environmental Protection Agency (EPA) lacks full information on firms' circumstances it may be uncertain whether, in response to a prohibition on the use of a certain polluting production technology, firms will comply by using a cleaner production technology (desirable reaction) or build their plants in another country, taking with them the jobs that those plants could have provided (undesirable reaction). Or the IRS may be uncertain whether, in response to a prohibition on the use of a certain tax-planning strategy, firms will comply by paying a higher tax (desirable reaction) or simply waste resources to jump through a few extra hoops before obtaining the desired tax outcome (undesirable reaction).[24]

What distinguishes the different policy-making instruments that administrative agencies may choose? A central contribution of the Article is to clarify how policy-making instruments vary along two important dimensions. The first dimension is the timing of policy making, that is, whether the policy is adopted before firms act (ex ante) or afterwards (ex post), and who chooses this timing. The second dimension is the breadth of policy making, that is, whether the policy adopted is broad or narrowly tailored to each firm's circumstances. Though some writers in the existing administrative law literature have noted one of these

(2008); Matthew C. Stephenson, *Information Acquisition and Institutional Design*, 124 Harv L Rev 1422 (2011).

[22] One such attempt is Emerson H. Tiller and Pablo T. Spiller, *Strategic Instruments: Legal Structure and Political Games in Administrative Law*, 15 J L, Econ & Org 349 (1999) (analyzing the choice between rule making and adjudication, but focusing on the strategic interaction between agencies and courts).

[23] A formal model on which most of the analysis in the Article is based is available upon request.

[24] See David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 Colum L Rev 1312, 1315 (2001); Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters, and the Compaq Case*, 88 Tax Notes 221, 223 (July 10, 2000).

dimensions,[25] this Article is the first to emphasize both dimensions and consider their effect on the choice of policy-making instrument.

Using this framework I first analyze administrative agencies' choice between rule making and adjudication. Since each firm knows its unique circumstances, under a policy-making instrument of adjudication it is able to predict how the administrative agency will use this information in future adjudication, taking this prediction into account in its current choice of actions. Thus adjudication is a way for agencies to harness information that they currently lack but that firms have in order to narrowly tailor the policy to each firm's circumstances and influence firms' current actions.

However, adjudication takes place after firms have already acted, which may affect administrative agencies' choice of policy. This introduces two strategic problems that were not acknowledged in the existing literature: *the holdup problem* and *the leniency problem.*

The holdup problem arises because after firms have acted, they cannot easily undo their actions. This makes it more tempting for agencies to adopt a strict legal position in adjudication, as firms will be forced to comply with such a position. However, expecting to be held up in adjudication, firms will avoid certain actions, choosing instead activities that may be less desirable.

To illustrate the holdup problem, the EPA may be tempted to claim in adjudication that the use of a technology in a plant was illegal, as firms cannot relocate their plants to another country once they are built and will therefore be forced to comply with such a ruling. However, expecting to be held up once they build their plants, firms will choose to invest in another country to begin with, taking with them the jobs that the plants could have provided. Similarly, the IRS may be tempted to adopt a strict position on the use of a certain tax-planning strategy related to the taxation of natural gas, knowing that firms will be forced to comply with such a position once a gas field is discovered. However, expecting to be held up once they use the planning strategy, firms may choose to explore in another country to

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[25] See, for example, Baker, 22 L & Contemp Probs at 660–61 (cited in note 3) (dismissing the timing concern as "almost axiomatic" in favor of ex ante rules before defending rules against the concern of narrowness in depth); Robinson, 118 U Pa L Rev at 517–19 (cited in note 3) (discussing the prospective and retroactive natures of rules and adjudication).

begin with, thus eliminating a source of energy, jobs, and tax revenue.[26]

The agency may avoid the holdup problem by issuing a rule in which it commits to a permissive policy. Thus, the EPA may issue a rule stating that the use of the technology is legal. Or the IRS may issue a rule adopting a lenient position with respect to the taxation of income from natural gas.

The leniency problem arises because after firms have acted they may find it impossible or too costly to comply with a strict legal position in adjudication. This may force the agency to adopt a lenient legal position in adjudication. And since firms know that by acting they can force the agency to adopt a lenient position in adjudication, they will do just that.

To illustrate the leniency problem, the FTC may be reluctant to claim in adjudication that a certain type of merger is illegal, since it may be impossible to restore competition fully once that merger has taken place, and also because reestablishing competition is usually very costly for the parties and the public.[27] This encourages firms to undertake this type of merger, knowing that the FTC will adopt a lenient legal position with respect to it in adjudication. Likewise, a department of buildings in a city may be reluctant to claim in adjudication that a certain type of building that has already been built does not meet city standards, since this would impose prohibitive costs on all the apartment owners who have already populated the building. This however encourages builders to build this type of building, knowing that the city will adopt a lenient legal position with respect to it in adjudication.[28]

The agency may avoid the leniency problem by issuing a rule in which it commits to a prohibitive policy. Thus, the FTC may issue a rule stating clearly that that type of merger is illegal.

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[26] This problem could be mitigated if the EPA and the IRS have reputational concerns. However, administrative agencies often put a greater weight on short-term, rather than long-term, outcomes, and political pressure may also drive an agency to act against its own long-term interest. See discussion in Part II.E.

[27] See FTC Premerger Notification Office, *What Is the Premerger Notification Program?* 1 (2009), online at http://www.ftc.gov/sites/default/files/attachments/premerger-introductory-guides/guide1.pdf (visited May 21, 2014).

[28] This problem could be mitigated if the FTC and the department of buildings have reputational concerns. However, administrative agencies often put a greater weight on short-term, rather than long-term, outcomes, and political pressure may also drive an agency to act against its long-term interest. See discussion in Part II.E.

Or the department of buildings may issue a rule stating clearly that this type of building is illegal.

Thus, relative to rule making, adjudication harnesses information that firms have to narrowly tailor the policy to each firm's circumstances, but it also introduces the holdup and the leniency problems. How should administrative agencies choose between rule making and adjudication? If firms are relatively homogenous, that is, when most of them are expected to have the same reaction to a policy, then agencies should choose rule making as a policy-making instrument, since then the gains from narrowly tailoring the policy are small, and rule making prevents the holdup and the leniency problems from arising. When firms are heterogeneous, that is, when they are expected to have different reactions to a policy, then agencies should choose adjudication as a policy-making instrument, since then the gains from narrowly tailoring the policy are large, though using adjudication means that the holdup and the leniency problems will arise.

I then introduce the policy-making instruments of advance ruling and licensing into the analysis. Under a policy-making instrument that supplements adjudication with advance ruling, each firm has to decide whether to request an advance ruling on the legality of an act before undertaking it. When firms request advance rulings, administrative agencies learn their unique circumstances. A policy-making instrument of licensing simply makes obtaining an advance ruling mandatory rather than optional. How does the introduction of advance ruling and licensing affect the analysis?

Advance ruling allows administrative agencies to commit ex ante to a policy that is narrowly tailored to each firm's circumstances. However, since firms are the ones who choose whether to request an advance ruling, they do so only when they expect the holdup problem to arise in adjudication, and not when they expect the leniency problem to arise, as the latter problem benefits them. Still, since the holdup problem is detrimental to administrative agencies, and advance ruling eliminates it, supplementing adjudication with advance ruling is desirable.

To illustrate the effect of advance ruling, a firm will request an advance ruling from the EPA on the use of a technology in a plant only if it expects the EPA to hold it up in adjudication by adopting a strict legal position on the use of a technology, knowing that after the plant is built the firm will have to comply with

this position. If a firm expects the EPA to adopt a lenient legal position on this issue in adjudication, knowing that a strict position will force the firms to shut down the plant, it will not request an advance ruling, as waiting for adjudication benefits the firm. Though the firm will request an advance ruling only when it is beneficial to it, advance rulings are still beneficial to the EPA, as they prevent cases in which firms' fear of a future holdup forces them to undertake alternative investments that are socially less desirable.

Licensing makes it mandatory for firms to have the act preapproved and therefore allows administrative agencies, in all cases, to commit ex ante to a policy that is narrowly tailored to each firm's circumstances, thus eliminating both the holdup and the leniency problems. However, this comes at a cost, as under licensing firms are required to obtain a license even in cases in which neither problem arises, that is, even in cases in which administrative agencies' choice of policy in adjudication is not affected by the fact that firms have already acted. This means that in some cases licensing imposes unnecessary costs on firms and administrative agencies, and slows down economic activity.

To illustrate the effect of licensing, if each firm has to preapprove the use of a technology with the EPA before building the plant, then if the technology is approved there would be no risk of a holdup in adjudication, and if it is not there would be no risk of the leniency problem arising in adjudication. However, it also means that licenses have to be obtained by firms even in cases in which there is no risk of a holdup or a leniency problem arising in adjudication, which is costly to the firms and the EPA, and slows down economic activity.

I conclude Part I by noting three policy implications of the game-theoretic framework. First, administrative agencies should supplement adjudication with advance ruling. Second, administrative agencies should utilize licensing as a policy-making instrument to a greater extent than they currently do. Third, administrative agencies should consider how different firms are from each other as an important factor when choosing among policy-making instruments. Specifically, when firms are relatively homogenous, that is, when most of them are expected to have the same reaction to a policy, then agencies should choose rule making as a policy-making instrument. When firms are relatively heterogeneous, that is, when they are expected to

have different reactions to a policy, then agencies should choose either licensing or adjudication supplemented with advance ruling.

In Part II, I extend the framework of analysis and consider how the analysis in Part I would change if other factors are considered. I first consider firms' ability to appeal administrative agencies' decisions in court, because the level of deference courts are willing to grant administrative agencies may depend on the policy-making instrument that was used to adopt the policy. Second, I consider the precedential effects of agencies' decisions under different policy-making instruments, and their effect on the choice of policy-making instruments. Third, the effect of nonprocedural costs that administrative agencies bear is considered, and its insignificant effect on the analysis is noted. Fourth, I consider situations in which firms are uncertain as to the policy that will be adopted by administrative agencies, showing that this generally makes adjudication less attractive, unless the agency benefits from firms' uncertainty. Finally I discuss reputational considerations and their effect on the holdup and leniency problems, noting how they may mitigate these problems, though in most cases these problems are still expected to arise.

I. CHOOSING AMONG POLICY-MAKING INSTRUMENTS

In Section A, I present the game-theoretic framework of analysis, laying out the problem that administrative agencies face and characterizing the different policy-making instruments. To make the analysis clearer, in Section B, I focus only on administrative agencies' choice between rule making and adjudication. Then in Section C, advance ruling and licensing are introduced into the analysis. In Section D, I conclude by making three concrete policy recommendations based on the analysis in the preceding Sections.

A. Framework of Analysis

1. Administrative agencies' objective.

Administrative agencies are not free to choose any policy they would like, as they are constrained by the language of the law. However, in many cases they must choose from a set of policies that are all permitted under the language of the law. Furthermore in many cases the law gives explicit discretion to the agency to take into account policy considerations. What guides administrative agencies in their choice of policy in these situations?

When choosing among possible policies administrative agencies usually consider the effect of their policy choice on some policy objective. This objective could be some statutory objective[29] or another policy objective. For example, the EPA is likely to consider the effect of its policy choice on pollution when choosing among possible policies. The IRS is likely to consider the effect of its policy choice on tax revenue when choosing among possible policies. Both are also likely to consider the effect of their policy choice on employment. What matters for the analysis is not necessarily what each agency's policy objective is, but the fact that when choosing a policy administrative agencies consider *some* policy objective, and not only fidelity to the language of the law.

2. Administrative agencies' problem.

Given administrative agencies' objective, and their possible choice of policies, they are faced with a problem. They are uncertain which policy will further this objective.

The reason for administrative agencies' uncertainty as to the desired policy is their lack of information on firm-specific circumstances. Because of it, administrative agencies are not sure how firms will react to the policy.

To make things concrete, consider a specific example that I will return to in this Part. The EPA contemplates prohibiting the use of a certain polluting production technology by firms, but it is uncertain whether firms' reaction to this prohibition will be desirable or undesirable. Because the agency lacks full information on firms' circumstances, it is uncertain whether, in response to a prohibition on the use of the technology, firms will comply with the new prohibition by using a cleaner production technology (desirable reaction) or build their plants in another country, taking with them the jobs that those plants could have provided (undesirable reaction). Many other administrative agencies face similar situations.[30]

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[29] See Shapiro, 78 Harv L Rev at 928 (cited in note 3) ("[S]pecific rules may . . . inadvertently set[ ] up guideposts for evasion of the basic statutory objectives.").

[30] The IRS may be uncertain whether, in response to a prohibition on the use of a certain tax-planning strategy, firms will comply by paying a higher tax (desirable reaction) or simply waste resources to jump through a few extra hoops before getting the desired tax consequences anyway (undesirable reaction). See Schizer, 101 Colum L Rev at 1315 (cited in note 24):

If, following a prohibition on the use of the technology, all firms use a cleaner technology, the use of the technology should be prohibited. If, following a prohibition on the use of the technology, all firms build their plants in another country, the use of the technology should be permitted. If some use a cleaner technology and others build plants in another country, the optimal policy, from the agency's perspective, depends on the unique circumstances of each firm which determine its expected reaction to the prohibition. But the agency does not know each firm's unique circumstances. The optimal policy thus depends on information that the agency does not have but firms do.

It is worth distinguishing between the above-mentioned type of uncertainty, that is, administrative agencies' uncertainty as to the desired policy, and another type of uncertainty, which is firms' uncertainty as to administrative agencies' choice of policy. Though these two types of uncertainty are analytically different, the existing literature either conflates the two,[31] or emphasizes only the latter.[32] Firms' uncertainty as to administrative agencies'

> [I]n recent years the government has used . . . narrow reforms that target specific planning strategies. Sometimes these transactional responses stop the targeted transaction. But in other cases taxpayers press on, tweaking the deal just enough to sidestep the reform. These avoidable measures cannot raise revenue or increase the tax burden on wealthy taxpayers. Instead, end runs consume resources and warp transactions, yielding social waste.

Shaviro, 88 Tax Notes at 223 (cited in note 24) ("[T]he desirability of an economic substance approach depends on two main things. . . . The second is the extent to which it succeeds in generating such deterrence rather than simply inducing taxpayers to jump through a few extra hoops before getting the desired tax consequences anyway.").

[31] See, for example, Baker, 22 L & Contemp Probs at 661–62 (cited in note 3) (noting that an "agency may not know enough about the particular problem to warrant issuance of rule-making," which reflects a problem of agency uncertainty, but also that it is desirable that an agency give firms a definitive guide to its actions, which reflects a problem of firms' uncertainty); Weisbach, 84 Cornell L Rev at 1640 (cited in note 1) ("Between relatively fixed points, there is a continuous range of transactions, and within the range there is considerable doctrinal uncertainty. . . . Assuming that the end points are fixed, the difficult question for *taxpayers and tax policymakers* is how to deal with the transactions in the middle.") (emphasis added).

[32] See, for example, Louis Kaplow, *Rules versus Standards: An Economic Analysis*, 42 Duke L J 557, 569 (1992) ("Individuals are uncertain of the actual content of the law."); Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 L & Contemp Probs 673, 697 (1969) ("The chief *advantage* of a detailed tax statute is that it provides certainty as to most of the matters covered by the detail."); Bernstein, 79 Yale L J at 590 (cited in note 3) ("The principal advantage of rule making is that it provides a clear articulation of broad agency policy. By contrast, the entire array of the Board's adjudicatory decisions on a subject often gives a diffuse, overly subtle mosaic of current NLRB doctrine.").

choice of policy is certainly important, but its effect on the choice between rule making and adjudication has been thoroughly analyzed.[33] This analysis could be summarized, in very broad strokes, with the statement that the policy maker should bear the cost of issuing a rule to declare its policy when the problem of firms' uncertainty is significant, that is, when it affects the actions of many firms.[34]

In this Article I focus on the issue of administrative agencies' uncertainty as to the desired policy, analyzing its effect on administrative agencies' choice of policy-making instruments. The focus on the problem of administrative agencies' uncertainty sheds light on new issues that have not been considered. However, in Part II of the Article I take again the issue of firms' uncertainty as to administrative agencies' choice of policy and consider its effect on the analysis in this Part.

3. Policy-making instruments.

What distinguishes the different policy-making instruments that administrative agencies may choose? In this Article I consider two dimensions along which these policy-making instruments vary. First, the timing of policy making, that is, whether the policy is adopted ex ante, before firms act, or ex post, after they act, and who chooses this timing. Second, the breadth of policy making, that is, whether the policy adopted is broad or narrowly tailored.

With respect to the timing of the policy-making instruments, rule making is an ex ante instrument, as rules are issued before an act is undertaken.[35] By contrast, adjudication is an ex

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The emphasis in the existing literature on firms' uncertainty is especially clear when one notes how the problem of retroactivity plays a major role as one of the disadvantages of adjudication, since this problem arises only when firms are uncertain as to the policy that will be adopted. See Friendly, *Federal Administrative Agencies* at 146 (cited in note 3) ("Another merit of the policy statement is its utility in avoiding what may be a harsh retroactive application."); Baker, 22 L & Contemp Probs at 662 (cited in note 3) ("[I]t is obviously desirable to avoid, if possible, the harsh effect of *retroactive* application of agency policy inherent in the case-by-case method."); Shapiro, 78 Harv L Rev at 933 (cited in note 3).

33 See generally Kaplow, 42 Duke L J 557 (cited in note 32).

34 See id at 577 ("In summary, the greater the frequency with which a legal command will apply, the more desirable rules tend to be relative to standards. This result arises because promulgation costs are borne only once, whereas efforts to comply with and action to enforce the law may occur rarely or often.").

35 In other words, rules are usually prospective. 5 USC § 551(4) ("'[R]ule' means the whole or a part of an agency statement of general or particular applicability and future

post instrument, as it takes place after an act is undertaken.[36] Licensing is an ex ante instrument, as one must obtain a license before undertaking an act. Advance ruling allows firms to choose the timing of policy making—if an advance ruling is requested the policy is adopted ex ante, and if not it is adopted ex post, in an adjudicative process.

With respect to the breadth of the policy-making instruments, adjudication is narrowly tailored to the specific circumstances of the firm that has undertaken the act.[37] By contrast, rule making tends to be broad, meaning not as narrowly tailored as adjudication.[38] Both licensing and advance ruling are narrowly

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effect."). In principle, a rule that is not "nominally retroactive" may still have retroactive effect, by, for example, changing the value of assets that were acquired prior to its enactment. See Michael J. Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U Pa L Rev 47, 49–50, 57–58 (1977); Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 Harv L Rev 509, 515–19 (1986). Nevertheless, what matters here is that relative to adjudication, rule making is more prospective, or alternatively less retroactive. See also Shapiro, 78 Harv L Rev at 933–35 (cited in note 3); Robinson, 118 U Pa L Rev at 518–19 (cited in note 3).

[36] In other words, adjudication is usually retroactive (though in theory it can be restricted to future cases). See *Bowen v Georgetown University Hospital*, 488 US 204, 221 (1988) (Scalia concurring) ("Adjudication *deals* with what the law was; rulemaking deals with what the law will be."). The difference in timing between rule making and adjudication is well noted in the literature. See Baker, 22 L & Contemp Probs at 658 (cited in note 3) ("[R]ule-making is agency action regulating future conduct . . . while adjudication is intended to cover application of law and policy to past conduct."); Fuchs, 59 Nw U L Rev at 793 (cited in note 3):

> A commonly recognized difference between rule-making and adjudication is that the latter usually operates retroactively, without prior notice to the parties concerned, when new legal ground is broken by a decision, whereas the kind of rule-making which enacts new law, binding in subsequent adjudication, ordinarily takes effect only as of its date.

Kaplow, 42 Duke L J at 560 (cited in note 32) (the "distinction between rules and standards is the extent to which efforts to give content to the law are undertaken before or after individuals act") (emphasis omitted).

[37] See Peck, 70 Yale L J at 758 (cited in note 3) ("A principal advantage of the *ad hoc* approach is that it permits consideration of, and adjustment for, the individual differences and factors found in particular cases.").

[38] See Davis, *Discretionary Justice* at 17 (cited in note 3) ("Rules without discretion cannot fully take into account the need for tailoring results to unique facts and circumstances of particular cases."); Isaac Ehrlich and Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J Legal Stud 257, 268 (1974):

> The inherent ambiguity of language and the limitations of human foresight and knowledge limit the practical ability of the rulemaker to catalog accurately and exhaustively the circumstances that should activate the general standard. Hence the reduction of a standard to a set of rules must in practice create both overinclusion and underinclusion.

Richard A. Posner, *The Problems of Jurisprudence* 44 (Harvard 1990) ("A rule suppresses potentially relevant circumstances of the dispute . . . while a standard gives the trier

tailored to the specific circumstances of firms, as firms present these circumstances when applying for them. Table 1 summarizes the characteristics of the four policy-making instruments.

TABLE 1. POLICY-MAKING INSTRUMENTS

	Broad	Narrowly Tailored	
Ex Ante	Rule Making	Licensing	Advance Ruling
Ex Post		Adjudication	

The four policy-making instruments in Table 1 vary along other dimensions as well.[39] However, the timing and breadth of policy making are particularly important dimensions. In Part II of the Article I consider the effect of other dimensions along which the policy-making instruments vary on the analysis in this Part.

Note that the choice between rule making and adjudication, as characterized above, can also be viewed as a choice between

of fact—the judge or jury—more discretion because there are more facts to find, weigh, and compare."); Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 Harv L Rev 1685, 1689 (1976) ("The choice of rules as the mode of intervention involves the sacrifice of precision in the achievement of the objectives lying behind the rules."); Frederick Schauer, *Rules and the Rule of Law*, 14 Harv J L & Pub Pol 645, 647 (1991) (rules "are necessarily general rather than particular").

In theory rules can be as narrowly tailored as adjudication. See Kaplow, 42 Duke L J at 586–88 (cited in note 32). However, they almost always are not. One explanation for this is that rules require the description of a situation in words, whereas in adjudication (or licensing) the situation is simply observed, which means that there is no need to describe it, and therefore all that the administrative agency needs to say is whether it is legal. If describing a situation is difficult and thus costly, especially in complex situations, one would expect rules to be less narrowly tailored than adjudicative decisions.

[39] The administrative law literature notes other differences between rule making and adjudication. See, for example, Magill, 71 U Chi L Rev at 1390–96 (cited in note 3) (noting the difference in process, legal effects, and availability and scope of judicial review); Shapiro, 78 Harv L Rev at 930–42 (cited in note 3) (noting the difference in the opportunity for general comment, the policy makers' ability to select policy issues, the flexibility of procedure, the accessibility and clarity of the policy formulation, and judicial review).

rules and standards. Standards are narrowly tailored and are often applied in an adjudicative process. Rules are broad, as noted, and are clearly issued in a rule-making process. The choice between rules and standards has received substantial attention from legal commentators.[40] Therefore, much of the analysis in this Article relates to that literature.

4. Administrative agencies' costs.

The different policy-making instruments are associated with procedural costs that administrative agencies bear. The process of rule making is costly for administrative agencies. Similarly, an adjudicative process involves certain costs to administrative agencies. In order to process requests for advance rulings and licenses a certain apparatus has to be set up, and processing each request is costly as well.

In addition to procedural costs, other costs may be borne by administrative agencies. After firms act administrative agencies may have to bear certain costs in order to learn which act each firm has undertaken, and to learn about each firm's unique circumstances. To simplify the analysis and focus on the main insights of the Article I ignore these nonprocedural costs in this Part. That is, I assume that, after firms act, administrative agencies simply observe which act each firm has undertaken and learn about each firm's circumstances. However, in Part II of the Article I take again the issue of nonprocedural costs and show that taking these costs into account does not fundamentally change the analysis.

B. Rule Making versus Adjudication

Administrative agencies have to decide whether to issue a broad rule that prohibits or permits a certain act, or to leave the matter for future adjudication. Adjudication is carried out after

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[40] See, for example, Roscoe Pound, *An Introduction to the Philosophy of Law* 111–23 (Yale 1954); H.L.A. Hart, *The Concept of Law* 121–32 (Oxford 1961); Frederick Schauer, *Playing by the Rules: A Philosophical Examination of Rule-Based Decision-Making in Law and in Life* 104 (Oxford 1991); Davis, *Discretionary Justice* at 15–21 (cited in note 3); Ehrlich and Posner, 3 J Legal Stud at 258–59 (cited in note 38); Posner, *Problems of Jurisprudence* at 42–53 (cited in note 38); Kennedy, 89 Harv L Rev at 1695–1701 (cited in note 38). See generally Kaplow, 42 Duke L J 557 (cited in note 32). But see Magill, 71 U Chi L Rev at 1403–04 n 69 (cited in note 3) ("There is no necessary connection between choice of form and the rule/standard distinction. An agency could use a legislative rule to announce either a rule or a standard.").

firms act. At this point the agency learns each firm's unique circumstances[41] and can adopt a policy that is narrowly tailored to those circumstances.

What affects administrative agencies' choice of policy-making instrument? What are the advantages and disadvantages of each instrument?

1. Narrowly tailored policy.

Choosing adjudication as a policy-making instrument is a way for an administrative agency to inform firms that the policy on the relevant legal question will be decided in the future, when the agency has more information about each firm's circumstances. However, though the policy will be adopted only in the future, it has a current effect on firms' choice of actions. The reason is that each firm has the information on its unique circumstances that the agency currently lacks. Thus, each firm is able to predict how the agency will use this information in adjudication. This prediction is taken into account by each firm in its current choice of action.

Accordingly, adjudication is a way for administrative agencies to harness information that they currently lack but that firms have in order to narrowly tailor the policy to each firm's circumstances and influence each firm's current actions. If administrative agencies choose the policy-making instrument of rule making, by contrast, they are unable to narrowly tailor their policy to each firm's circumstances.

2. Ex post policy making.

So far we have seen that relative to rule making, adjudication harnesses information that firms have to narrowly tailor the policy to each firm's circumstances. However, since adjudication takes place after firms act, administrative agencies' choice of

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[41] That policy makers are better informed in the adjudicatory stage is well noted in the administrative law literature on the choice between rule making and adjudication. See, for example, Fuchs, 59 Nw U L Rev at 789–90 (cited in note 3) ("[S]olutions in rulemaking will sometimes be reached to a large extent without detailed evidence as to the specific situations to be governed by the regulations, such as formal adjudicatory proceedings would supply."); Baker, 22 L & Contemp Probs at 661 (cited in note 3) ("The agency may not know enough about the particular problem to warrant issuance of rulemaking. . . . It may, therefore, be necessary to proceed on a case-by-case basis until the necessary experience . . . has been accumulated."); Posner, *Problems of Jurisprudence* at 44 (cited in note 38) ("[A] standard gives the trier of fact—the judge or jury—more discretion because there are more facts to find, weigh, and compare.").

policy under a policy-making instrument of adjudication may be influenced by that fact. The reason for this is that firms may react differently to a policy that is adopted ex post, after they have already acted, than to a policy that is adopted ex ante, before they have done so.

To be more specific, two problems arise when adjudication is used as a policy-making instrument: the holdup problem and the leniency problem. To better explain these problems I will use again the example of the EPA that contemplates prohibiting the use of a certain polluting production technology.

a) Holdup problem. This problem arises because after firms have already built plants that utilize the production technology, they cannot simply move the plants to another country. This makes it more tempting for the EPA to claim in adjudication that the use of the technology was illegal, as firms will be forced to comply with this ruling and remake their plants.

However, since firms can predict that ex post, after they have undertaken their investments, the EPA will hold them up by prohibiting the use of the production technology in adjudication, if adjudication is used as a policy-making instrument these firms will refrain from building plants that use the technology and instead choose to build plants in another country, which is undesirable from the agency's perspective.[42]

The agency may avoid the holdup problem by committing to permit the use of the polluting technology. The agency does precisely that when it uses rule making as a policy-making instrument and issues ex ante a rule that permits the use of the technology. A rule binds the agency, which allows firms to build plants that utilize the technology, knowing that the agency will not be able to claim ex post that its use was illegal.

b) Leniency problem. This problem arises because after firms have already built plants that utilize the production technology, they may find it impossible (or too costly) to remake them in order to comply with a prohibition of its use. This makes the EPA reluctant to claim in adjudication that the use of the

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[42] The inefficiency resulting from the holdup problem is a standard result in the economic literature on incomplete contracting. See Oliver E. Williamson, *The Vertical Integration of Production: Market Failure Considerations*, 61 Am Econ Rev 112, 115–16 (1971); Benjamin Klein, Robert G. Crawford, and Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J L & Econ 297, 302–07 (1978). See generally Sanford J. Grossman and Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J Polit Econ 691 (1986).

technology was illegal, as firms may shut down their plants following such a decision.

Since firms know that by undertaking investments that utilize the production technology they can force the EPA to permit its use in adjudication, if adjudication is used as a policy-making instrument these firms will do just that.[43] The agency can avoid this problem by committing to prohibit the use of the technology, which it does by using rule making as a policy-making instrument, and issuing ex ante a rule that prohibits the use of the technology.

Note that while the holdup problem is detrimental to firms, the leniency problem is beneficial to them. However, both problems are detrimental to administrative agencies. This is clear for the leniency problem, in which the agency is forced to adopt a lenient legal position because firms have already acted. However, it is also true for the holdup problem. In the case of the holdup problem firms that expect to be held up by the agency in adjudication may choose alternative activities that are less desirable from the agency's perspective.

3. Choosing between rule making and adjudication.

As noted, relative to rule making, adjudication harnesses information that firms have to narrowly tailor the policy to each firm's circumstances, but it also introduces the two problems that result from ex post policy making. How should administrative agencies choose between rule making and adjudication?

Administrative agencies' choice of policy-making instrument depends on the heterogeneity in circumstances of firms. If firms

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[43] This situation is known as commitment in the economics literature. See Thomas C. Schelling, *Strategies of Commitment and Other Essays* 1 (Harvard 2006), defining commitment as

> becoming committed, bound, or obligated to some course of action or inaction or to some constraint on future action. It is relinquishing some options, eliminating some choices, surrendering some control over one's future behavior. And it is doing so deliberately, with a purpose. The purpose is to influence someone else's choices. Commitment does so by affecting that other's expectations of the committed one's behavior.

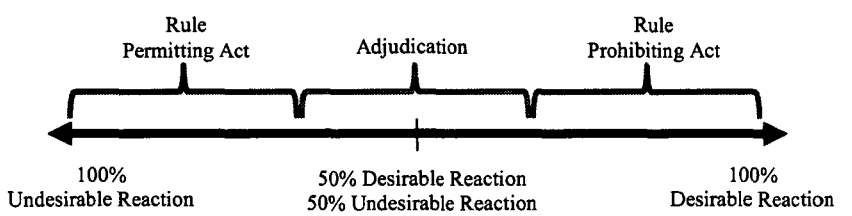
A famous historical example of commitment is when, according to the legend, the Spanish Conquistador Hernando Cortés burned the ships that brought his men to the New World after his men got ashore. He wanted his men to understand fully that their only option was to win or die—there would be no retreat. Knowing their options were limited now, the Spanish army would fight harder and with more determination. See Winston A. Reynolds, *The Burning Ships of Hernán Cortés*, 42 Hispania 317, 319 (1959) (discussing both the legend and historical facts and situation).

are relatively homogenous, so the agency knows that most firms' reaction to a chosen policy will be desirable, or that most firms' reaction will be undesirable, agencies should choose rule making as a policy-making instrument.[44] Though rule making is costly, it prevents the holdup and the leniency problems from arising, and although it does not allow the agency to narrowly tailor its policy to each firm's circumstances, the gains from narrowly tailoring the policy are relatively small when firms are relatively homogenous.

By contrast, if firms are heterogeneous, so the agency's only guess is that firms will be more or less evenly split between those with a desirable reaction to the policy and those with an undesirable one, agencies should choose adjudication as a policy-making instrument.[45] Though under adjudication the holdup and the leniency problems arise, it allows the agency to harness information that firms have to narrowly tailor the policy to the each firm's circumstances. This is particularly important when firms are expected to differ so much in their reaction to the policy, and therefore a simple broad policy will have significant adverse results.

Administrative agencies' choice of policy-making instrument is illustrated in Figure 1:

FIGURE 1. CHOICE OF POLICY-MAKING INSTRUMENT



The horizontal line in the figure represents the heterogeneity of firms' reactions to a policy that would prohibit a certain act. The right end of the line represents a case in which all firms will react to a policy in way that is desirable from the agency's

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44 See Diver, 95 Harv L Rev at 431 (cited in note 3) ("The synoptic paradigm should be the preferred way to make policy in relatively stable environments.").

45 See id at 430 ("The singular advantage of incrementalism is its ability to accommodate uncertainty and diversity."); Baker, 22 L & Contemp Probs at 661 (cited in note 3) ("The agency may not know enough about the particular problem to warrant issuance of rule-making.").

perspective. The left end of the line represents a case in which all firms will react to the policy in a way that is undesirable from the agency's perspective. When firms are relatively homogenous in their reaction to the policy, administrative agencies should choose a policy-making instrument of rule making, issuing either a rule that prohibits an act or a rule that permits it. When firms are relatively heterogeneous in their reaction to the policy, which is the middle part of the line in Figure 1, administrative agencies choose a policy-making instrument of adjudication.[46]

C. Licensing and Advance Ruling

The analysis in Section B considered administrative agencies' choice between rule making and adjudication. In this Section I introduce two additional policy-making instruments into the analysis: advance ruling and licensing.

If administrative agencies adopt a policy-making instrument that supplements adjudication with advance ruling, then each firm has to decide whether to request an advance ruling on the legality of a contemplated act before undertaking it or to undertake the act without an advance ruling, letting the agency determine its legality in adjudication. A policy-making instrument of licensing simply makes obtaining an advance ruling mandatory rather than optional. That is, firms must have the act preapproved before undertaking it.

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[46] The "check the box" rules are an example of a case in which taxpayers' reaction to a policy was expected to be undesirable, and therefore a permissive rule was issued. Before these rules were adopted the classification of foreign entities for US tax purposes as corporations or pass-through entities was determined by a six-factor test. These factors included: (1) continuity of life, (2) centralization of management, (3) limited liability, and (4) free transferability of interest. If an entity lacked any two of these factors it would generally not be taxed as a corporation, but as a partnership. See Rev Rul 88-8, 1988-1 Cum Bull 403. Since the test was malleable, taxpayers could often attain the status they desired, but had to waste resources to get there, which was undesirable. Accordingly, the IRS gave up on restricting entity characterization, and allowed taxpayers to choose whether designated entities will be treated as corporations or pass-through entities for tax purposes. See Treas Reg § 301.7701-3(a).

One example of a case in which taxpayers' reaction to a policy was expected to be desirable, and therefore a prohibitive rule was issued, is the rule on nonrecognition of realization in sales of property to related parties. Generally speaking, a sale or exchange of property triggers recognition of a gain or loss. 26 USC § 1001(c). This creates an incentive to undertake a wash sale, by selling property to related parties in order to claim the unrealized loss as a tax deduction, but still holding on to the property through the related person in the hope that it will recover its value. To deal with such a possibility tax authorities simply do not allow the deduction of any loss from the exchange of property between related parties. See 26 USC § 297(a)(1), (b).

When firms request an advance ruling or a license, administrative agencies learn their unique circumstances. With this information the agencies decide whether to permit or prohibit the act to each firm.

To better understand the effect of these two policy-making instruments on the analysis it is helpful to make two pairwise comparisons.

1. Advance ruling versus adjudication.

Recall that, under a policy-making instrument of adjudication two problems arise because administrative agencies' ex post choice of policy may be influenced by the fact that firms have already acted: the holdup problem and the leniency problem. If firms request an advance ruling, this eliminates these two problems, as such a request allows administrative agencies to commit ex ante to a policy that is narrowly tailored to each firm's circumstances. Recall, however, that although both problems are detrimental to administrative agencies,[47] from the firms' perspective the holdup problem is detrimental, while the leniency problem is beneficial. Since the firms are the ones who choose whether to request an advance ruling under a policy-making instrument of advance ruling, they will do so only when the holdup problem arises, not when the leniency problem arises. This means that under a policy-making instrument of advance ruling only the holdup problem is eliminated, but not the leniency problem.

Thus, relative to a policy-making instrument of adjudication, a policy-making instrument of advance ruling harnesses information that firms have as to cases in which the holdup problem arises, thus eliminating it. This comes at a cost, as advance-ruling requests are costly to process. But if this cost is not too high, supplementing adjudication with advance ruling is desirable.

2. Licensing versus advance ruling.

As noted, a policy-making instrument of advance ruling eliminates the holdup problem that arises under adjudication, but does not eliminate the leniency problem, as firms get to choose whether to request an advance ruling, and they do so only when the holdup problem arises. A policy-making instrument

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[47] See Part I.B.2.b.

of licensing, by contrast, takes away firms' ability to choose whether to request an advance ruling, by making it mandatory for firms to have their actions preapproved. This allows administrative agencies, in all cases, to commit ex ante to a policy that is narrowly tailored to each firm's circumstances, thus eliminating both the holdup problem and the leniency problem.

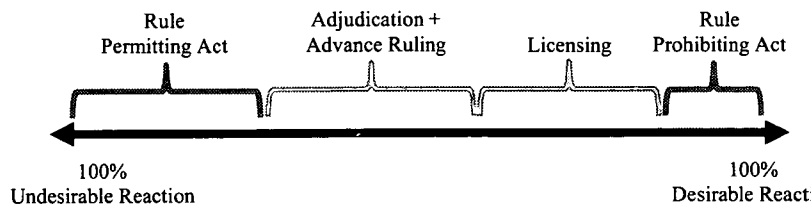
This advantage of licensing over advance ruling, however, comes at a cost. Though administrative agencies' ex post choice of policy may be influenced by the fact that firms have already acted, there are situations in which this issue does not arise. In other words, there are situations in which administrative agencies' choice of policy is not affected by the fact that firms have already acted, and therefore neither the holdup problem nor the leniency problem arises. In these situations a policy-making instrument of licensing, which requires firms to preapprove their actions in all cases, simply imposes unnecessary costs of processing licenses on administrative agencies and firms. By contrast, under a policy-making instrument of advance ruling, firms will not request an advance ruling when the holdup problem does not arise, knowing that such a request will have no effect on the agency's ultimate choice of policy.

Thus, relative to a policy-making instrument of advance ruling, a policy-making instrument of licensing eliminates both the holdup problem and the leniency problem, but it also requires a license even in situations in which these problems do not arise, thus imposing unnecessary costs on the agency. The more likely administrative agencies are to approve an act in a request for a license, the more requests will be filed, and the higher the costs of processing these requests will be, making advance ruling, which reduces the number of such requests by allowing firms to invest without prior approval, relatively more appealing than licensing.

3. Choosing a policy-making instrument.

Given the above pairwise comparisons, Figure 2 illustrates administrative agencies' choice of policy-making instrument, which depends on the heterogeneity in circumstances of firms.

FIGURE 2. CHOICE OF POLICY-MAKING INSTRUMENT



If administrative agencies think that almost all firms' reaction to a policy that prohibits a certain act will be desirable, which is the right end of the horizontal line, then a rule that prohibits the act is the optimal policy-making instrument. Although unlike licensing, such a rule does not allow the agency to permit the act to the few firms for which it would be desirable to do so, given how few in number these firms are the benefit from narrowly tailoring the policy to their unique circumstances does not justify the cost of setting up a licensing apparatus.

As we move left on the horizontal line, more firms' reaction to a policy that prohibits the act will be undesirable, which means that administrative agencies would like to permit the act to more firms. At this point licensing becomes the optimal policy-making instrument. Licensing allows administrative agencies to prohibit the act to most firms in a relatively efficient way, as these firms will not request a license knowing that their request will be denied, while still maintaining the ability to permit it to some firms, who will request a license.

As we continue moving to the left on the horizontal line, more firms' reaction to a policy that prohibits the act will be undesirable, which means that the agency would like to permit the act to more firms. Supplementing adjudication with advance ruling is the optimal policy-making instrument in this region, since relative to licensing it reduces the number of firms' requests that have to be processed, as firms are allowed to act without prior approval. However, this comes at a cost of introducing the leniency problem, as firms will not request an advance ruling when that problem arises in adjudication, as they benefit when it does. Still, the leniency problem becomes less significant as we move further to the left, that is, as the agency would actually like to permit the act to more and more firms.

Finally, as we get to the left end of the horizontal line, most firms' reaction to a policy that prohibits the act will be undesirable,

and therefore issuing a rule that permits the act becomes the optimal policy-making instrument. Such a rule allows the agency to adopt a policy without processing many requests for advance rulings, but this comes at a cost of giving up the ability to narrowly tailor the policy to those few firms' for which it would be desirable to prohibit the act.

Another way to understand administrative agencies' choice of policy-making instrument in Figure 2 is by focusing on the benefits and costs of licensing and advance ruling relative to rule making. The policy-making instrument of licensing allows agencies to commit to a policy that is narrowly tailored to each firm's circumstances, but involves the cost of setting up a licensing apparatus and of processing individual requests for a license. When it is desirable to permit an act to only a few firms, it is not worthwhile bearing the cost of setting up a licensing apparatus for those few firms. When it is desirable to permit an act to most firms, licensing is too costly, as too many requests for licenses will have to be processed. Licensing is thus the optimal policy-making instrument when it is desirable to permit the act to enough firms so that it is worthwhile to bear the cost of setting up a licensing apparatus, but not to too many, as then it would be too costly to process all the requests for a license.

The policy-making instrument of advance ruling, which supplements adjudication with the option of obtaining an advance ruling, allows agencies to narrowly tailor the policy to each firm's circumstances, but involves the cost of processing individual requests for an advance ruling, and also introduces the leniency problem, as firms will not request an advance ruling when this problem arises. When it is desirable to prohibit the act to most firms, this problem is significant, as many firms will attempt to avoid the desired policy by undertaking the act. When it is desirable to prohibit the act to only few firms, advance ruling is too costly, as many requests for an advance ruling will have to be processed (though less than under licensing). Advance ruling is thus the optimal policy-making instrument when it is desirable to prohibit the act to enough firms so that not that many requests for an advance ruling have to be processed, but not to too many, as then the effect of the leniency problem that arises under advance ruling becomes significant.[48]

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[48] When processing requests for a license or an advance ruling, as well as setting up a licensing apparatus, are very costly, we go back to the analysis in Part I.B, in which administrative agencies could choose only between rule making and adjudication.

D. Policy Implications

I now consider three concrete policy implications of the game-theoretic framework that was presented and analyzed in this Part.

1. Supplementing adjudication with advance ruling.

One important implication of the analysis is that supplementing adjudication with advance ruling is desirable. Providing firms with the opportunity to request an advance ruling on the legal consequences of contemplated acts prevents cases in which firms' fear of a holdup in adjudication leads them to choose activities that are less socially desirable. Thus, administrative agencies should allow firms to obtain an advance ruling.

This is often not the case. Many administrative agencies offer no procedure for obtaining advance rulings. For instance, the Equal Employment Opportunity Commission (EEOC) does not provide a procedure by which firms may preapprove hiring procedures. Other agencies that provide such procedures put heavy restrictions on their use. The EPA, for example, has an explicit policy against the issuance of advance rulings, or what it calls No Action Assurances, except "in extremely unusual cases."[49] The IRS also places some restrictions on the type of advance-rulings request that taxpayers can make.[50] Based on the analysis in the previous Section, these policies seem unwarranted and do not seem to be explained by the cost of processing requests.

2. Using licensing as a policy-making instrument.

Another important implication of the analysis is that licensing is the optimal policy-making instrument in a wide range of situations, as shown in Figure 2. Licensing is particularly desirable

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Administrative agencies' choice of policy-making instrument in that case is illustrated in Figure 1.

[49] Environmental Protection Agency, *Policy Against "No Action" Assurances* (Nov 16, 1984), online at http://www2.epa.gov/sites/production/files/2013-10/documents/noactionass-mem.pdf (visited May 21, 2013). A recent example of such an extremely unusual case is a no-action assurance that was issued regarding standards that industrial boilers have to meet. See Environmental Protection Agency, *No Action Assurance regarding Certain Work Practice or Management Practice Standard Deadlines in the March 2011 Area Source Boiler Rule* (Mar 13, 2012), online at http://www.epa.gov/boilercompliance/20120313NAA.pdf (visited May 21, 2014).

[50] See Rev Proc 2012-7, 2012-1 Int Rev Bull (detailing "areas where the Service will not issue letter rulings or determination letters").

when the leniency problem is likely to arise, that is, in cases in which the agency will find it difficult to claim in adjudication, after an act was undertaken, that the act was prohibited.

Despite the benefits of licensing, licensing as a policy-making instrument seems underutilized by administrative agencies. For example, one could imagine that the IRS would benefit from requiring some types of investments, say those passing through the Cayman Islands or Bermuda, to be preapproved in order to receive certain tax benefits. This would prevent situations in which the IRS learns about new tax-planning strategies only after they are widely used, which makes it more difficult for the IRS to claim they are illegal. Similarly, the SEC could require that certain activities, known to often involve a conflict of interest, be preapproved with SEC before they are undertaken.[51] Thus, administrative agencies should utilize licensing as a policy-making instrument to a greater extent than they currently do.

3. Heterogeneity versus homogeneity of firms.

A third implication of the analysis is that a central factor in administrative agencies' choice among the four policy-making instruments should be the heterogeneity in circumstances of firms, as shown in Figure 2. Specifically, when firms are relatively homogenous, so the agency knows that most firms' reaction to a chosen policy will be desirable, or that most firms' reaction will be undesirable, agencies should choose rule making as a policy-making instrument. When firms are relatively heterogeneous, so the agency's only guess is that firms will be more or less evenly split between those with a desirable reaction to the policy and those with an undesirable one, agencies should choose either licensing or adjudication supplemented with advance ruling. In this region, the more firms have an undesirable reaction to the policy, the more likely it is for adjudication supplemented with advance ruling to be superior to licensing, as shown in Figure 2.

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[51] See Carlo V. di Florio, *Conflicts of Interest and Risk Governance*, Speech to the National Society of Compliance Professionals (Oct 22, 2012), online at http://www.sec.gov/News/Speech/Detail/Speech/1365171491600#.UkM7_mTXj40 (visited May 21, 2014) (mentioning certain areas with potential for conflicts of interest that are currently a high priority).

II. ADDITIONAL FACTORS

In this Part, I consider different factors that were not addressed in the analysis in Part I. I analyze how accounting for each factor affects that analysis.

A. Appeals

In the analysis in Part I, I did not consider the possibility that firms may appeal the policy chosen by administrative agencies. How does the possibility of an appeal affect the analysis in Part I?

The possibility of an appeal may affect the analysis in Part I because the level of deference courts are willing to grant administrative agencies may depend on the policy-making instrument that was used to adopt the policy.[52] When rules are adopted by Congress, they simply bind courts. If they are adopted through regulations, they are awarded the two-step *Chevron* deference.[53] This means, in practice, that a rule will be upheld as long as it is a reasonable construction of what Congress has said. By contrast, administrative agencies' reliance on less formal policy-making instruments, such as advance rulings, is subject to a less deferential standard than the *Chevron* standard, articulated in *Skidmore v Swift & Co*,[54] as determined in *United States v Mead Corp*.[55]

Thus courts are more deferential to policies adopted in rules than to policies adopted through other policy-making instruments. This makes the policy-making instrument of rule making more desirable from the perspective of administrative agencies.

However, there are certain disadvantages with the use of rule making as a policy-making instrument that are related to the possibility of an appeal. The use of rule making as a policy-making instrument facilitates judicial review, as it allows firms

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52 See Magill, 71 U Chi L Rev at 1394–99 (cited in note 3). See also Stephenson, 120 Harv L Rev at 528 (cited in note 21) (analyzing how the fact that courts give administrative agencies more latitude when they promulgate their interpretive decision via an elaborate formal proceeding rather than in a more informal context affects the procedural formality with which the agencies promulgate their interpretations).

53 *Chevron U. S. A. Inc v Natural Resources Defense Council, Inc*, 467 US 837, 843–44 (1984).

54 323 US 134, 140 (1944) ("The weight [accorded to an administrative] judgment in a particular case will depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control.").

55 533 US 218, 234–35 (2001).

to immediately obtain judicial review by showing that they are affected by the rule.[56] Furthermore, since rule making makes the policy issues visible and clear to the public eye, it facilitates judicial scrutiny of administrative agencies' policy judgments.[57] Policies that are declared in adjudication are more likely to survive judicial challenge than those declared in rules, since when adjudication is used the reviewing court may agree with the rule as stated and affirm on that ground or, even when it doubts the validity of the policy, affirm on the ground that the result in the particular case is sound.[58] Finally, when administrative agencies choose rule making as a policy-making instrument they assume sole responsibility for the overall soundness of the policy. This increases the likelihood of the court adopting a narrow outlook on the policy, and siding with firms, regardless of possible adverse consequences.[59]

B. Precedent

The analysis in Part I did not consider the issue of precedent. Two separate questions arise in this respect. The first is how the choice of policy-making instrument determines the precedential value of the policy adopted. The second is how the analysis in Part I changes if the policies adopted under the different policy-making instruments do set a precedent.

Addressing first how the choice of policy-making instrument determines the precedential value of a policy, a necessary (though not sufficient) condition for a policy to set a precedent is for it to be made available to the public. But administrative

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[56] Shapiro, 78 Harv L Rev at 941 (cited in note 3) ("[A] formal announcement of the agency's position in a regulation may permit an individual to obtain judicial review even before any action has been taken in a particular case, if he can show that his ordering of his affairs is plainly affected by the very existence of the regulation."); Baker, 22 L & Contemp Probs at 665 (cited in note 3) ("When the policy has been formulated in a rule . . . that rule can immediately be challenged . . . by some interested party who is adversely affected.").

[57] Robinson, 118 U Pa L Rev at 526 (cited in note 3); Tiller and Spiller, 15 J L, Econ & Org at 360–61 (cited in note 22).

[58] See Shapiro, 78 Harv L Rev at 944–45 (cited in note 3).

[59] See Jerry L. Mashaw and David L. Harfst, *Regulation and Legal Culture: The Case of Motor Vehicle Safety*, 4 Yale J Reg 257, 302–09 (1987) (noting that the National Highway Traffic Safety Administration's adjudicative recall activity was much more successful in courts than its regulations, which were often reversed by courts. Their explanation is that in recall proceedings the agency was acting only as litigant, thus passing on the responsibility for the overall soundness of the policy to the court, which, being risk-averse, was hesitant to deny recalls).

agencies' choice of policy-making instrument often determines whether their policy is published. While rules are published, adjudicative decisions, especially those made by low-level agency employees, are often not.[60] The outcome of a licensing process is often known, as one can find out whether an organization has obtained a license, but agencies do not formally publish these licensing decisions and their reasoning. As for advance rulings, they sometimes are made available to the public, but not always.[61]

As noted, publication is not a sufficient condition for a chosen policy to set a precedent. Even if a policy choice is made public, the policy-making instrument chosen may affect the policy's precedential value. While rules set a precedent, adjudicative decisions may have a weaker precedential effect.[62] Advance rulings, even when they are published, often have an explicitly limited precedential value.[63] Still, the publication of a policy may give it a de facto precedential effect, because of administrative agencies' duty of consistency toward similarly situated firms.[64]

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60 For example, in the tax context, adjudicative decisions are determinations of deficiency in tax, which are not published. 26 USC § 6212(a). See also Michael I. Saltzman, *IRS Practice and Procedure* ¶ 1.08[2] (Warren Gorham & Lamont Revised 2d ed July 2011) ("Determinations of deficiency in tax . . . appear[ ] to constitute an adjudication within the meaning of the APA.").

61 For example, Internal Revenue Service Private Letter Rulings were made available to the public only after the Internal Revenue Service lost two freedom-of-information cases requesting their disclosure in the mid-1970s. See generally *Tax Analysts and Advocates v Internal Revenue Service*, 505 F2d 350 (DC Cir 1974); *Fruehauf Corp v Internal Revenue Service*, 566 F2d 574 (6th Cir 1977). See also Donald E. Osteen, Lori J. Jones, and Howard S. Fisher, *The Private Letter Ruling Program at the Half Century Mark*, 42 USC Tax Inst 12-1, 12-11 to -15 (1990).

62 See Shapiro, 78 Harv L Rev at 951 (cited in note 3) ("[B]y eschewing regulations in favor of the declaration of rules by adjudication, an agency is likely to regard itself as freer, and will in fact be given greater freedom by the courts, to ignore or depart from those rules in specific instances without giving sufficient reasons."); Magill, 71 U Chi L Rev at 1396 (cited in note 3) ("[Adjudication's] precedential effect may be limited by some facts peculiar to the chosen target, and, in any event, it does not bind all parties in the same way that a valid legislative rule would.").

63 For example, the precedential value of IRS Private Letter Ruling is formally limited. 26 USC § 6110(k)(3) ("[A] written determination may not be used or cited as precedent.").

64 For an example in the tax context, see *United States v Kaiser*, 363 US 299, 308 (1960) (Frankfurter concurring) ("The Commissioner cannot tax one and not tax another without some rational basis for the difference."); Lawrence Zelenak, *Should Courts Require the Internal Revenue Service to Be Consistent?*, 38 Tax L Rev 411, 412–15 (1985). Reflecting the de facto precedential value of published opinions, advance tax rulings are treated as precedential in practice. Jason Chang, et al, *Private Income Tax Ruling: A Comparative Study*, 10 Tax Notes Intl 738, 740 (1995) ("[I]n practice, private letter rulings are widely read and relied upon in tax planning.").

Turning to how the analysis in Part I changes if the policies adopted do set a precedent, consider first the case in which a firm-specific decision is precedential in the sense that the same policy must apply to other firms with similar circumstances. Recall that the administrative agency's choice of policy in adjudication is influenced by the fact that firms have already acted, which results in two problems, the holdup problem and the leniency problem. If decisions in adjudication are precedential then the agency still takes into account the effect of its choice of policy on firms that have already acted, but it will also consider the effect of that decision on firms that have yet to act. The greater that latter group is relative to the former group, the less likely these two problems are to arise, which makes adjudication a relatively more desirable policy-making instrument.

If the agency's decisions in a request for an advance ruling or a license are precedential, then it will have to process fewer such requests, as firms with similar circumstances will know that the same policy will apply to them. This makes both advance ruling and licensing more desirable policy-making instruments.

Another possibility to consider is when a firm-specific decision is precedential in the sense that the same policy applies to all firms, even if their circumstances are different. Such a case arises when the agency is unable to describe in enough detail in its decision the firm's exact circumstances. This may be a plausible situation, because if those circumstances were easy to describe, one could adopt a rule that is as narrowly tailored as an adjudicative decision. In such a case, if decisions in adjudication, advance ruling, and licensing set a precedent, they can be viewed simply as rules, as they apply a policy to all firms, which makes these policy-making instruments less desirable.

C. Nonprocedural Costs

As noted in Part I.A.4, the analysis in Part I ignores nonprocedural costs. That is, it assumes that, after firms have acted, administrative agencies can costlessly observe which acts each firm has undertaken and learn each firm's circumstances. How would these costs affect the analysis in Part I?

Note that there are two types of nonprocedural cost that have to be considered separately: (1) the cost of monitoring firms' actions, to learn which act each firm has undertaken, and (2) the cost of learning each firm's unique circumstances.

Let us begin with the effect of the cost of monitoring firms' actions. Under all policy-making instruments, administrative agencies need to monitor firms to see whether they complied with the law. Under rule making, if a rule that prohibits the act is issued, administrative agencies have to monitor firms to see whether, despite the rule, they have undertaken the act. Under licensing, administrative agencies have to monitor firms to see whether they have undertaken the act without a license. Under adjudication and advance ruling, administrative agencies have to monitor firms to see whether they complied with the policy desired by the agency.

If it is costly to monitor firms' actions, then administrative agencies will not monitor each and every firm, because doing so would be too costly.[65] With imperfect monitoring some firms will not comply with the law, which means that, in addition to monitoring costs, administrative agencies will have to bear the cost of bringing enforcement actions in certain cases. Furthermore, with imperfect monitoring, firms will have a lower incentive to apply for an advance ruling or a license, since it may be cheaper for them to undertake the act without prior approval. However, penalties that are inversely proportional to the probability of monitoring may be introduced to deter firms from not complying with the law, even under imperfect monitoring.[66]

For the purpose of this Article, what matters is that, since under all policy-making instruments firms' actions have to be monitored, the introduction of monitoring costs does not have a differential effect on some policy-making instruments, and therefore it does not fundamentally alter the analysis in Part I. The only effect we get is that with monitoring costs, issuing a rule that permits the relevant act and therefore requires no monitoring becomes more appealing.

Now let us turn to the cost of learning each firm's unique circumstances. This cost has a differential effect on some policy-making instruments. Specifically, when this cost is taken into consideration, a policy making of adjudication, or one that supplements adjudication with advance ruling, becomes less desirable, as

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65 This is clear if one starts from the case in which an agency spend resources to monitor all firms. In such a case all firms will comply with the law, as they know that if they do not they will always be caught. With full compliance, the agency has an incentive on the margin to reduce monitoring to save on monitoring costs.

66 See generally Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J Polit Econ 169 (1968); A. Mitchell Polinsky and Steven Shavell, *The Optimal Tradeoff between the Probability and Magnitude of Fines*, 69 Am Econ Rev 880 (1979).

under adjudication administrative agencies bear the cost of learning each firm's circumstances to narrowly tailor the policy to each firm's unique circumstances.

By contrast, the policy-making instruments of rule making and licensing are relatively unaffected by this cost. Rules are not narrowly tailored (or, more accurately, not as narrowly tailored) by definition, and since they flatly permit or prohibit the act administrative agencies need only to monitor firms' actions when rule making is the policy-making instrument. Under licensing, firms come up to the agency and reveal their unique circumstances, and therefore agencies do not need to bear the full cost of learning these circumstances on their own.[67]

D. Firms' Uncertainty as to Policy

As noted in Part I.A.2, the analysis in Part I is abstract from the problem of firms' uncertainty as to the agency's choice of policy, focusing instead on the problem of the agency's uncertainty as to the desired policy.

The issue of firms' uncertainty as to an agency's choice of policy, and its effect on the choice between rule making and adjudication, was thoroughly analyzed by Louis Kaplow.[68] The analysis here follows the basic insights of that article.

When firms are uncertain about the agency's choice of policy, a policy-making instrument of adjudication becomes less desirable. The reason is that each firm will not be able to predict which policy the agency will adopt in adjudication given the firm's unique circumstances. Each firm will choose its actions given the expected policy that will be adopted in adjudication. If firms' expectations are sufficiently different from how the agency really decides, then firms will choose the wrong actions. This means that adjudication will fail to harness information that firms have to narrowly tailor the policy to each firm's circumstances.

In this setting, rule making has the additional advantage of resolving all uncertainty about the agency's choice of policy, thus providing clear guidance to firms. Licensing also has the same additional benefit, but now under licensing some requests for a license will be rejected, as firms cannot accurately predict how

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[67] Even if an agency has to bear a certain cost to verify that the information provided by firms, in their request for an advance ruling or a license, is correct, what matters for the analysis is only that this cost is lower than the cost of learning this information in adjudication.

[68] See Kaplow, 42 Duke L J at 557 (cited in note 32).

the agency will rule on their request. Furthermore, even firms whose actual actions are not affected by their uncertainty will have to request a license.

Advance ruling under this setting has the additional benefit of harnessing information that firms have as to cases in which resolving their uncertainty affects their choice of action. Under a policy-making instrument of advance ruling, only in these cases will firms choose to request an advance ruling.

So far I assumed that administrative agencies benefit from firms' ability to predict what policy the agencies will adopt in adjudication. However, this is not always the case. As shown in Part I, firms' ability to predict what policy an agency will adopt in adjudication also creates two problems, the holdup problem and the leniency problem. In these instances administrative agencies may benefit from firms' inability to predict what policy will be adopted in adjudication. Thus, in such cases firms' uncertainty as to the agency's choice of policy will only make adjudication a relatively more desirable policy-making instrument.

E. Ex Post Policy Making and Repeat Interactions

In the analysis in Part I, the main disadvantage of a policy-making instrument of adjudication is that it introduces two problems, the holdup problem and the leniency problem. In the economics literature, the holdup problem has been especially emphasized in the incomplete-contracting literature,[69] as well as in the context of optimal monetary policy, in which it is more commonly known as the problem of time inconsistency of optimal policy.[70] In the monetary policy literature it was noted that in a setting with a repeated interaction between the policy maker and private agents, reputational forces can serve to overcome the holdup problem.[71] A similar argument can be made in our case. Agencies are not likely to hold up firms in adjudication since they know that this will cause firms, in the long run, to undertake activities that are less socially desirable. Similarly,

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69 See literature noted in note 42.

70 See Finn E. Kydland and Edward C. Prescott, *Rules Rather than Discretion: The Inconsistency of Optimal Plans*, 85 J Polit Econ 473, 477 (1977); Robert J. Barro and David B. Gordon, *A Positive Theory of Monetary Policy in a Natural Rate Model*, 91 J Polit Econ 589, 598–99 (1983); Kenneth Rogoff, *The Optimal Degree of Commitment to an Intermediate Monetary Target*, 100 Q J Econ 1169, 1169 (1985).

71 See Robert J. Barro and David B. Gordon, *Rules, Discretion, and Reputation in a Model of Monetary Policy*, 12 J Monetary Econ 101, 102 (1983).

the leniency problem will not arise because agencies know that it will encourage firms, in the long run, to act in a socially undesirable way, knowing that ex post agencies will be forced to adopt a lenient position towards them.

Thus, in situations in which we think administrative agencies have a long-term objective, both the holdup problem and the leniency problem are less likely to arise under adjudication, which makes adjudication a more desirable policy-making instrument. But this is not always the case, because administrative agencies often put a greater weight on short-term, rather than long-term, outcomes. This seems particularly true when thinking of the people involved in adjudication. They are in that position for a relatively short amount of time, and their success is often measured by their short-run outcomes.[72]

Furthermore, though the framework in Part I assumes rational administrative agencies that maximize some objective, there might be nonrational explanations to a phenomenon along the same lines as the holdup and the leniency problems. Specifically, the leniency problem, in which administrative agencies are reluctant to claim that an act is prohibited after firms have undertaken it, reflects the known phenomenon that it is easier to ask forgiveness than it is to get permission. The holdup problem, in which administrative agencies are tempted to claim that an act is illegal after firms have undertaken it, can be simply the result of political pressure.[73]

Finally, for long-term reputational concerns to overcome the holdup and leniency problems it must be clear to outside observers when administrative agencies' decisions are a result of a

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[72] See, for example, General Accounting Office, *IRS Personnel Administration: Use of Enforcement Statistics in Employee Evaluations* 8–10, 28–33 (1998), online at http://www.gao.gov/assets/230/226666.pdf (visited May 21, 2014) (noting the widespread perception among IRS employees that promotion depends on enforcement results). One IRS employee noted that "any successful revenue agent knows that low time and high dollars will result in recognition, promotion, and awards." Id at 40. This was true despite a specific prohibition on the use of enforcement results to evaluate employees. Treas Reg § 801.3(e)(1) ("No employee of the IRS may use records of tax enforcement results . . . to evaluate any other employee or to impose or suggest production quotas or goals for any employee.").

[73] One example is political pressure to redistribute great wealth that was gained from investments that originally had a very low probability of success. Examples of such investments are investments in exploring for natural resources in places where they are unlikely to be found. In such situations tax authorities often want to commit to a low tax on entrepreneurs, to encourage explorations, since once significant reserves of oil or gas are found the public might not agree to such low taxation, ignoring the original low probability of success and demanding higher taxes to redistribute the wealth.

holdup or leniency situation and when they are not. But this often is not the case.[74]

CONCLUSION

This Article makes several contributions to the administrative law literature. First, the existing administrative law literature focuses only on the policy-making instruments of rule making and adjudication. This Article identifies two additional policy-making instruments that have been ignored thus far: advance ruling and licensing. Second, the Article identifies the two central dimensions along which each of the four policy-making instruments available to agencies may be characterized: timing and breadth. Third, the Article introduces two strategic problems that may arise under adjudication, which were not considered in the existing literature: the holdup and the leniency problems. Fourth, the Article provides the first comprehensive analysis of administrative agencies' choice among the four policy-making instruments available to them. And fifth, the Article argues that administrative agencies should use advance rulings and licensing more than they currently do.

While the Article focuses on administrative law, its insights apply well outside that field. In particular, much of the analysis is relevant to the vast literature on the choice between rules and standards in different areas of law. The idea that standards can be applied ex post (adjudication) or ex ante (licensing), and that the timing of the application may also be left to be decided by the person to whom the standard applies (advance ruling), has not been considered in that literature. Furthermore, the two strategic problems that are highlighted in the Article, the holdup problem and the leniency problem, are also relevant to the choice between rules and standards.

More broadly, the Article utilizes a specific methodological approach. It employs a game-theoretic framework to answer a fundamental question in administrative law. This methodological approach may be applied to address legal questions in other settings, both in administrative law and in other areas of law. In all of these settings, explicit recognition and analysis of the strategic

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[74] In the realistic case with nonprocedural costs and firms' uncertainty as to the agency's policy, firms' compliance is not perfect, and therefore the agency often has to bring enforcement actions. In such a setting it is difficult to infer what considerations drive an agency in each of its decisions.

interaction between agencies and firms may lead to new insights and a better understating of doctrine as well as legal institutions.