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THE PROSPECT OF INTEGRATION THROUGH INCOMPLETE CONTRACTING

Yusuf Ausiandra^{1*}

Law and economics (L&E) as an interdisciplinary tool bridges the realms of analytical economics and law. Albeit widely accepted as theoretically separate, the construction of international public law treaties could be paralleled at a structural formative level with private contracts. Incomplete contracting as a branch of contractual L&E permits to comprehend the dynamics of drafting an economically efficient contract and hence also international treaties. Incomplete contracting analysis hereby would be applied to the development of the Association of Southeast Asian Nations (ASEAN) regarding cooperation and the possibility of future integration from a contractual standpoint.

Keyword(s): law, economy, ASEAN, integration

I. INTRODUCTION

International contracts have long influenced international relations and subsequently international law itself. The bundle of contracts formulated, sustained and enforced between different sovereigns along history has contributed to the preservation of a minimum of “predictability” and “certainty” in international constellation of powers. After, the Second World War and the end of the cold war, sovereigns have decided to avoid further world-scale hostilities and strive to establish a peaceful world environment.² This new stabilized environment permits the re-establishment and further development of trade amongst nations (transnational trade). The medium of creating concrete certainty either for nations or for private subjects (individuals and legal persons) would be through international contracts.

Despite the fact that forms of contract could vary and classified under different distinctive characters such as public or private or even constitutive, the fundamental elements of a contract could always be clearly defined. This also concerns contracts conducted between sov-

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² This is enshrined in the United Nations Charter where a peaceful settlement of disputes amongst states would be fundamental.

foreign nations more likely known under the terminology of “treaties”³. Treaties varies from bilateral types dealing with regulation of interest between two nations; multilateral treaties such as the World Trade Organization (WTO); regional treaties as in the European union or others.

Accordingly, the aim of this study would be to deconstruct the actual contractual structure of two main types of International Integration (Inter-governmental and Supranational) through the “Law and economics” theory of incomplete contracting. The elaboration of the theory of incomplete contract would then be applied to analyze the contractual structure of an international organization namely The *Association of South East Asian Nations* (ASEAN). The main parts of this essay would consist of: Part 1) The brief introduction of incomplete contracting and the application to the two main forms of international integration; Part 2) The ASEAN Structure; Part 3) An analysis of integration and the role of incomplete contracting; Part 4) Recommendation of further integration.

The first part would be on the theory of incomplete contracting. This new approach to law through economical perspectives has gain vivid attention in the legal *milieu*.⁴ Incomplete contracting theory is a concept that was at roots inspired by the works of Ronald Coase and of Oliver Williamson. Both economical writers contributed to the development on analyses of transactions costs and the function of contracts. According to both economical writers, contracts have the function of managing coordinative or subordinate relationships between parties in order to avoid future contingencies.⁵ Furthermore, through incomplete contracting, economical agents such as enterprises and in the framework of this paper also nation states have been theoretically deprived of a fundamental assumption that these contractual parties could define *ex ante* all possible adversities and risk in the course of business. The cost of listing all possible eventualities would be practically and epistemologically impossible.⁶ The underlying hypothesis of this concept resides on the assumption that the subjects to a contract would formulate a contract based on several possible approaches and factors that could

³ This is in accordance with Article 2 of the Vienna Convention on the Law of Treaties 1969, which states that a treaty is fundamentally an agreement between states.

⁴ Bernard Salanie, *The Economics of Contract*, 2nd ed., The MIT Press, 2005, p. 11.

⁵ Jean Tirole. *Bounded Rationality and Incomplete Contracts*. May 11, 2007. P. 3

⁶ *Ibid.*, p. 1

ex ante be calculated. This would be linked to the concept of *bounded rationality*, which affirms the limited possibilities in contract drafting and the high risk that it entails. Relating to this factual deficiency due to contingency, the role of an adjudicative third party would a positive gap-filler or even a pioneering element in face of the high risk and contingency environment.⁷

Divers types of international cooperation and integration could found yet two types of fundamental structure could be rooted out: Inter-governmental⁸ and federalism.⁹ In federalism itself, the constitution could be viewed as a form of international treaty¹⁰ but for the reason that in federalism the contract has taken further integration and politically having national application we would hereby analyze the conceptual construction of supranationalist treaties. From deconstructing both contract with the tools provided by the “incomplete contracting theory” we would be able to discern the distinguishing features in contractual construction between inter-governmentalism and supranationalism.

ASEAN has long been striving for further integration although limited by the structure still based on the concept of diplomatic cooperation between nations.¹¹ The advent of the ASEAN Charter has marked the move of the regional organization towards further integration in juridical terms.¹² Yet, if compared with other regional organization such as North Atlantic Free Trade Area (NAFTA) and the European Union, the level of integration is still very low. A bundle of literature purporting on the subject of integration could be found applying political or juridical approaches. This research attempts to understand the phenom-

⁷ B. Douglas Bernheim and Michael D. Whinston. *Incomplete Contracts and Strategic Ambiguity*. The American Economic Review. Vol. 88. No. 4 September 1998. PP.902- 932. J-Stor. P. 904

⁸ Sabine Saurugger, *Théories et concepts de l'intégration européenne*, Science Po Les Presse, 2009, p. 54.

⁹ *Ibid.*, p. 62

¹⁰ Francisco Forrest Martin, *The Constitution as Treaty: The International Legal Constructionalist Approach to the U.S. Constitution*. 2007: New York. Cambridge Press. P. 207

¹¹ Melda Kamil,, Lusita and Yusuf Ausiandra. *Pembangunan Bertahap Sistem Hukum ASEAN* (Gradual Establishment of ASEAN Community Law System). *Lembaga Pengkajian Hukum Internasional Universitas Indonesia* (Center For International Law Studies). 2011-2012 P. 79

¹² *Ibid.* P. 1

enon of integration *in casu* the ASEAN regional integration through the contractual constructions of the foundational contract (the ASEAN Charter). In the mist of applying a “*Law and economics*” point of view, the geo-political description of the environment would aid to understand the possibility of further integration from a non-juridical and economical perspective notably through the consideration of vital facts and circumstances of political variables. This would support or deter the idea of a regional integration conducted by a binding third party authority in the scope of the strategy to complete the process of incomplete contracting.

II. ECONOMIC THEORY OF CONTRACT, INCOMPLETE CONTRACTING AND REGIONAL INTEGRATION

In the historical flow of jurisprudence, the scientific and economic approach towards law has been initiated since Karl Marx and continued through Law and Economics. The failure by Hans Kelsen to maintain a purist approach¹³ of the juridical studies shattered the long maintained separation of law as an isolated science. This fostered further impetus in the legal scholarship towards an inter-disciplinary approach to law notably by adopting various perspectives form other disciplines such as economics, politics and even mathematics. Even though there have been extensive debates on the epistemological and practical validity of adopting “exact science” approach to legal as maintained by Kelsen himself,¹⁴ the success met by realist and neo-realism¹⁵ has further encouraged the implementation of quantitative approach to law.

One of the approaches that have adopted economical perspectives to law has been classified under the name of “Law and Economics”. This paradigm of theorizing legal issues through economical consid-

¹³ Hans Kelsen, *Pure Theory of Law*, transl. Reine Rechtslehre, University of California Press, 1967, p. 34.

¹⁴ Kelsen described that the relation between variables in “Exact science” such as mathematics and physics could be classified as causality while the relations between variables in social science including law and politics is “imputative”. Simply put, according to kelsen, social science could never adopt a quantitative approach because the human nature could not be predicted.

¹⁵ Charles Covell. Hobbes, *Realism and the Tradition of International Law*, Palgrave Macmilan, 2004, p. 86.

erations and concepts have been considered relevant to support the growing commercial and business environment. Related to its inherent nature, economical necessity has coined words that are considered as principles of law. The most important principles are “predictability” and “certainty”. These principles have even been enshrined in the preamble language of World Trade Organization (WTO) treaties,¹⁶ an important inter-governmental and multilateral level organization dealing with transnational trade. In accordance with the obvious obsession of creating an environment that could have maximum level of predictability and certainty, the subjects of business and trade have strived towards ensuring economical contingencies through law. One of the juridical instruments is through contracts that would be observable and in certain cases enforceable by coercion.¹⁷

Although, the main actors of trade and businesses including transnational businesses are mostly individuals and legal persons, states have also a major interest in assuring the certainty of trans-national trade for welfare and other reasons.¹⁸ WTO, constituted of governments that represent the interest of its citizens in international trade, strives to ensure certainty and predictability in International trade. At the first phases of its development, international trade had enormous problems with barriers to trade in form of tariffs. This results in the birth of the General Agreement in Tariff and Trade (GATT 1947). In the further historical development, GATT evolved into an organization under the name of World Trade Organization. This multilateral organization focusing in trade has regulated international trade through its successive negotiations and subsequent treaties regulating various aspects of trade. Yet, the success of this organizations in mitigating barriers to trade have encountered a sudden halt at the final negotiations known as the Doha Round. Fortunately that WTO law recognizes exceptions to its multilateral principles granting the possibilities of ensuring free trade at a

¹⁶ The Marrakesh Agreement establishing the World Trade Organization employed an integrative language for both developed trading nations and developing nations with the goal to facilitate trade.

¹⁷ Robert E. Scott and Paul B. Stephan. Self-enforcing International Agreements and The Limits of Coercion. Wisconsin Law Review 2004 Freedom from Contract Symposium. Westlaw Rev. 551. P. 11

¹⁸ Paragraph 3 of the Preamble of The Marrakesh Agreement Establishing The World Trade Organization

regional level in Article XX of the GATT 1947 incorporated as part of GATT 1994.¹⁹

Even though existing critics has been launched towards the use of law and economics, especially the contract theory to the international public law, there is a development towards the application of the view. The main argument would be the fundamental similarity of goal both between international public contracts and private contracts. This fundamental similarity would be the goal of contracting whether public or private, which consists of the joint production of social welfare.²⁰

Pertaining to development above, there are two important observations: 1) Transnational actors in trade and business including states ensure certainty and predictability through contracts between sovereigns or known as treaties under the Vienna Convention on Law of Treaties²¹; and 2) Transnational trade has been developing towards a myriad of clusters at a regional level in the same.²² As stated before, in order to assure certainty and predictability, nations formulate and conclude contracts between themselves. Through treaties, nations limit their powers and in some cases delegate some of their powers to a third authority depending on the level of integration and purpose of the treaties. The structure of the contract would determine the level of flexibility and discretionary power still remaining at the national level.

From this a theoretical analysis of the founding contract of one regional organization striving towards integration would be useful to support certain hypothesis on integration. In this essay, the regional organization of choice would be the Association of South East Asian Nations. The organization has still maintained a form of inter-governmental organization founded on the principles of diplomatic cooperation²³. In the other hand, ASEAN has demonstrated its will towards achieving a higher level of integration through several agreements notably in the

¹⁹ General Agreement on Tariff and Trade 1947

²⁰ Robert E. Scott and Paul B Stephan, *The Limits of Leviathan: Contract Theory and the Enforcement of International Law*, Cambridge University Press, p. 29.

²¹ Vienna Convention on The Law of Treaties 1969

²² Simon Lester and Bryan Mercurio, *Bilateral and Regional Trade Agreements Commentary and Analysis*, Cambridge University Press, p. 37.

²³ Article 2 ASEAN Charter

domains of trade.²⁴ The analysis of ASEAN would be limited to the dispute settlement mechanism and the over-all structure of it.

First of all we shall establish the theoretical framework into three parts: 1) Economic Theory of Contract; 2) The Incomplete contracting theory and 3) Regional integration (Inter-governmental v. constitutional structure). Before proceeding further with the concept of incomplete contracting, it would be better to elaborate the concept of contracting theory seen from the law and economic perspective.

A. Economic Theory of Contract

“Contract law and the courts help people to cooperate by enforcing, interpreting, and regulating promises. By enforcing promises, contract law enables people to make credible commitments to cooperate with each other. By enforcing promises optimally, contract law creates for efficient cooperation. Co-operation is efficient when the promisor invests in performing at the efficient level and the promise relies at the efficient level. By laying out guidelines for information that must be revealed and that may be kept secret in a contractual relationship, contract law seeks to induce optimal informational exchange within the contractual relationship. By interpreting promises and articulating efficient terms, contract law and courts reduce the cost of negotiating contracts by supplying efficient default terms. By regulating contracts, the courts can correct market failures. By correcting market failures from externalities, asymmetric information, and situational monopolies, contract law reduces the threat of opportunistic behavior undermines the willingness of people to make commitments to each other. Finally, contract law helps to solve the problem of cooperation with minimal reliance on the apparatus of the state. The problem of cooperation is solved with minimal reliance upon the state by fostering enduring relationships.”²⁵

As implicitly stated before above, parties to a treaty would have the choice of adopting the classical decentralized cooperation theory where the view of international cooperation problem is conducted through

²⁴ This could be seen in Article 3 of the ASEAN charter where legal personality has been established through the charter

²⁵ Robert Cooter and Thomas Ulen, *Law and Economics*, 4th ed., 2004. Boston: Pearson Addison Wesley. P. 235

the “prisoners dilemma” where the inefficient mutual noncooperation is the single-shot equilibrium.²⁶ In other words, this view relies on the view that the international relations environment as in an anarchical state where cooperation are made upon a void space. The alternative towards this point of view would be to compose a contingent contract to minimize the possible contingencies. In practice, state actors maximize joint mutual welfare towards pareto-efficiency and reduce the possible contingencies subsequently raising certainty through international treaties. The aforementioned fact, leads us to the relevancy of the use of the incomplete contracting theory in analyzing the economics of international treaty drafting.

B. Incomplete Contracting Theory

The concept of incomplete contracting hereby would be reduced into the necessary part relevant to the overall analyses of international treaties. To define the definition of “incomplete contracting, one must define the term contract itself. Under the light of incomplete contracting, a contract design would consist of:²⁷

- (i) Definition of number and nature of traded entitlements and the traded entitlements which would be simply the specified rights and obligations
- (ii) Definition of entitlement protection rules and remedies;
- (iii) The laying down of enforcement rules in case of contractual defection by one party over the other

Entitlements themselves could be elaborated into several types consisting of: a) substantive v. auxiliary entitlements; b) bilateral v. multi-lateral entitlements; c) Dependent v. general auxiliary entitlements. The protection granted to these entitlements would range from a. inalienability rules; b. liability rules; c. Property rules of protection.

The first types of entitlements consist of substantive and auxiliary entitlements. Substantive elements contain the level of cooperation, which each party is willing to concede in a contract. While, auxiliary

²⁶ Michael J Gilligan, *The Transactions Cost Approach to International Institutions*, New York University. P.7

²⁷ A.B Simon Schropp, *Trade Policy Flexibility and Enforcement in the WTO: A Law and Economics Analysis*, Cambridge University Press, 2009, p. 43.

entitlements specify the means in which the substantive goals can finally be achieved in the most efficient and effective manner.²⁸

The second types of entitlements are bilateral and multilateral entitlement. This categorization is based on the number of parties. For a bilateral entitlement the rule would be reciprocity between both parties. In the other hand, multilateral entitlements would concern all parties (owned by the entire membership).²⁹

The third types of entitlements consists of Dependent and general auxiliary entitlement. Dependent auxiliaries are dependent or “pegged” to a single substantive entitlement while a general auxiliary applies to multiple substantive entitlements.³⁰

An inalienability rule mandate or also known as “mandatory specific performance” mandates an unconditional specific performance of the contractual rules. Liability rules would protect through a form of collateral the *ex ante* trade entitlements. A property rule would consist of a protection of an entitlement with a punishment of any transgression. The property rule still gives the right of transfer of ownership over the entitlement. In a contract the types of entitlements are mixed depending on necessity and the level of complexity of the contract.

The ideal form of contract would be the complete contingent claims contract or pareto-efficient complete contingent contract (CCC). Pareto-efficiency or allocative efficiency is a particular situation where it would be impossible to alter the situation so as to make at least one person better off without making another person worse off³¹. This contract would be a contract that would give the highest benefit possible that could be obtained through a contract for both parties.³² This form of contract would constitute the benchmark for every possible contract as it is the hypothetically the “perfect contract”. Yet, it would be practically impossible to achieve the CCC contract for three main reasons³³:

²⁸ *Ibid.*, p. 44.

²⁹ *ibid*

³⁰ *ibid*

³¹ Robert Cooter and Thomas Ulen, *Law and Economics*, 4th ed., Pearson Addison Wesley, 2004, p. 16.

³² *ibid*

³³ A.B Simon Schropp, *Trade Policy Flexibility and Enforcement in the WTO: A Law and Economics Analysis*, Cambridge University Press, 2009, p. 29.

a) Transaction costs; b) bounded rationality and c) strategic considerations. The first reason namely transaction costs relates to uncertainty costs and enforcement costs. Parties to a contract would in general avoid drafting a CCC because it would be extremely costly to establish one by one the different contingencies that may occur in the course of the contract. This is the essence of transaction costs. Secondly, bounded rationality would be the circumstances where the parties would draft a contract solely based on the information that they could obtain at the moment of formulating and concluding the contract (*ex ante*). The final reason, strategic considerations, arises from the projection of gaining a favorable position based on potential changes of future. To ensure a capacity to seize benefit of those alterations, certain contingencies are voluntarily left out of the drafting process. The combination of these three reasons hinders the possibilities of drafting a CCC or complete contingent contract.

The reasons stated above forces parties to obtain an “*Incomplete Contract*” that could not foresee and contain all the possible contingencies. The incompleteness of the contract obtained leaves a room for flexibility in terms of policy.³⁴ Any attempt to draft a near complete contract beforehand due to the reasons above, especially the “bounded rationality” would render the contract too rigid and force the party to extra-contractually breach the contract (*ex-post regret*).³⁵

We could distinguish six logically distinct type of contract incompleteness: (1) Strategic incompleteness; (2) Accidental incompleteness; (3) Ignorance; (4) Inexorable incompleteness; (5) Type A or efficient incompleteness; 6) Type B or necessary incompleteness. The description of each form of incompleteness would be as following:³⁶

The first type of incompleteness would be the strategic incompleteness. This form of contractual incompleteness is a result of the field conditions know as “asymmetrical information” which could be described as a situation where despite that the parties could comprehen-

³⁴ *ibid*

³⁵ Luca Anderlini and Leonardo Felli. Bounded Rationality and Incomplete Contracts. Discussion Paper No. TE/00/407. December 2000. The Suntory Centre for Economics and Related Disciplines London School of Economics and Political Science. P. 7

³⁶ A.B Simon Schropp. Trade Policy Flexibility and Enforcement in the WTO: A Law and Economics Analysis. New York: Cambridge University Press, 2009, p. 69-73.

sively specify all relevant contingencies, different parties would still withhold specific states of nature that are only observable to the parties respectively and could not be verifiable by the other party or a neutral third party. Pertaining to this case, parties would prefer to leave certain verifiable aspects of performance ambiguous rather than specifying them explicitly as long as certain aspects of performances are non-verifiable.³⁷

The second type of incompleteness would be Accidental Incompleteness. This type of incompleteness derives from an ambiguous treaty language due to a mis-specification of the nature of a contingency. The uncertainty that arises is known as *ambivalence*.

The third type would be Ignorance. This incompleteness is purely due to uncertainty known as unforeseeability. In other words, the parties are in this case completely ignorant of any contingency at *ex-ante*. The debate is still open on whether the concept of *bounded rationality* could be inferred as the cause of *ignorance*. Yet, it would be difficult to pursue studies on *ex-ante* ignorance for the studies on the unknown would be far too difficult. So, according to Ayres and Gertner,³⁸ unforeseeable contingencies do not effect contracting parties decision or actions. Accidental incompleteness and ignorance form a type of incompleteness known as *inadvertent incompleteness*. In this type of incompleteness, the parties are trapped to believe that they have successfully and comprehensively embodied an issue in an unambiguous manner yet in fact the clause chosen would be subject to possible open interpretation – leaving gaps subsequently inducing potential abuse by third parties acting in bad faith.

The fourth type would be inexorable incompleteness. This type of incompleteness would be related to “incertitude in a narrow sense”. In this type, the outcomes and probability of a contingency could be foreseen while the contingencies could not be specified. It could be divided in two types where type A of *inexorable incompleteness* would deal with a situation where a contingency revelation can be expected

³⁷ B. Douglas Bernheim and Michael D. Whinston, “Incomplete Contracts and Strategic Ambiguity”, *The American Economic Review*, vol. 88, no. 4, September 1998, p. 903.

³⁸ Ayres and Gertner. 1989. “Filling Gaps in Incomplete Contracts: an Economic Theory of Default Rules. *Yale Law Journal* 99. PP. 87-130. P. 34

to be observable while type B of *inexorable incompleteness* would occur when a contract containing asymmetrical information give rise to incompleteness.

The fifth type of incompleteness would be Type A or efficient incompleteness. In this type, the parties would willingly draft an incomplete contracting under the light of symmetrically revealed contingencies due to constraints provoked by transaction costs that out-weight the benefit of identifying, enumerating and drafting all the possible contingencies. Efficient incompleteness could also be an option whenever efficient responses to contingencies are at a minimum variation yet non-specifiable beforehand.

The sixth type of incompleteness would be Type B or necessary incompleteness. This type of incompleteness consists of a combination of strategic and efficient incompleteness. In this type, some important contingencies are privately revealed to one party hence creating an incomplete contract that could not be filled or remedied at a short term during the course of execution with the prior condition that the parties are deemed to be rational actors.

The abovementioned incompleteness could result in general in three generic types of errors:³⁹

- Ambiguous and ambivalent treaty language, caused by poorly described contingencies and their outcomes;
- Insufficient language (Type-I errors or “false positives”), which provoke gaps and give rise to legal loopholes. The inclusion of excusable contingencies into a contract where there should not be any could provoke an abuse of opportunistic abuse by the enacting party
- Contractual rigidity (Type-II errors or “false negatives”) where in the contrary the contract has been too rigidly formulated that the contract wrongly prohibits non-performance where a complete contingent contract would actually have mandated welfare-enhancing *ex-post* adjustment.

There are 4 basic strategies trajectories of dealing with contractual

³⁹ A.B Simon Schropp. Trade Policy Flexibility and Enforcement in the WTO: A Law and Economics Analysis. New York: Cambridge University Press, 2009. P. 70

incompleteness for the signatories *inter alia*:⁴⁰

- (i) Minimizing the number of gaps through comprehensive contracting
- (ii) Seizing regret through drafting flexibility mechanism
- (iii) Minimizing the room for dispute by means of additional contract language and relational contracting
- (iv) Delegating gap-filling responsibility to third parties.

The first basic strategy trajectory could only be accomplished if the level of incompleteness is not too high and the costs of writing the detailed contract would not outweigh the gains of doing so. The attempt of this strategy namely comprehensive contracting would intend to obtain a CCC. It would be quite limited due to the high adversity of the contracting environment and the strategic opportunism that parties would like to preserve.

The second basic strategy trajectory would make recourse to contractual flexibility mechanism in order to seize the gains that *ex-post* regret contingencies pose. Through flexibility mechanism, parties could depart from originally agreed performance legitimately. Contractual flexibility differs from comprehensive contracting which lists down all the possible plan of action and transaction terms while contractual terms outline the basic rule of the game and tends to obtain the outcome of the CCC but not its content.

The third basic strategy trajectory would be by minimizing room for disputes through additional contract language. There are two possibilities of conducting this strategy *inter alia*: (1) precautionary drafting and (2) the use of preamble language, which lays out the general spirit of the contract and common intentions of the parties. The preamble language would serve neutral third parties (courts) as a point of reference when interpreting the contractual gap and would serve as commandments to deter the parties from conducting opportunistic behaviors.

The last strategy for remedying contractual incompleteness would be by delegating gap-filling authority to impartial third parties (courts). The courts would provide constructive gap-filling interpretation through formulating a clause in a way that the parties would have agreed *ex ante*,

⁴⁰ *Ibid.* P. 85

had they foreseen the existence of the contingency at hand.⁴¹ Courts are indispensable in situations of inadvertent contractual gaps needing to be filled and ambiguous contract language needs to be interpreted.

In a matrix the different strategies with dealing with contract incompleteness could be described as following:⁴²

Strategic trajectory of gap-filling	Tactical trajectory of gap filling	Tactical trajectory of gap filling
	General contract language	Specific contract language
<u>Towards completeness</u> (Fighting incompleteness)	Preamble language	Comprehensive contracting CCC Diligence
<u>Towards incompleteness</u> (embracing incompleteness)	Courts (delegation gap-filling to courts) Default Rules	Contingency measures

From the different strategies of dealing with different types of incomplete contracting stated above, it could be inferred that incompleteness could be resolved mainly at the drafting phase (*Ex-ante*) or by delegating a gap-filling role to third parties (*ex-post*). In practice, parties would apply a combination of the different strategies depending on the circumstances and information available. In the case of use of the gap-filling strategies by third parties (courts), the type of incompleteness would be inadvertent incompleteness.⁴³ As mentioned above, inadvertent incompleteness is a result of ambiguous language due to *ignorance* and *accidental* incompleteness. It is a failed attempt to provide clauses that embody completely a form of contingency in a general language that give rise to opposing interpretations from the parties.

In drafting, international treaties the parties would often encounter

⁴¹ A.B Simon Schropp. Trade Policy Flexibility and Enforcement in the WTO: A Law and Economics Analysis. New York: Cambridge University Press, 2009. P. 95

⁴² *ibid.* p. 98

⁴³ *ibid.* p. 74

such incompleteness. The signatories would formulate clauses in a general manner that would permit a wide residual policy space that could fall into the trap of inadvertent incompleteness. The parties would as the above matrix demonstrates embrace incompleteness and resolve to submit further conflict to third “gap-filling parties”.

C. Regional Integration

The concept of incomplete contracting and “gap-filling” roles of third parties in resolving inadvertent incompleteness above would be closely related to economical integration through a quasi-constitutional structure and constitutionalism. According to Dixit, constitutions are incomplete contracts that perform constitutional arrangements consisting of two elements⁴⁴. First, they lay down a set of rules for the conduct of economic policy that constraint the freedom of decision-makers. Secondly, recognizing that they cannot possibly anticipate every possible contingency, they lay down procedures for settling disputes when cases arise that are not covered by the rules laid down initially.⁴⁵ Furthermore, Brennan and Hamlin identify three reasons that motivate states to be bound by rules that they cannot easily escape or change (constitutional nature) consisting of:⁴⁶

- (1) The prisoner’s dilemma: Based on this isolation of paradox where the parties would individually prefer to act opportunistically while others obey the rules but on balance everyone gains by being constrained.
- (2) The assurance paradox: This concept would be that parties have no desire to break the rules so long as others obey.
- (3) Parties desire to bind themselves through institutions or rules to obtain a reputation of trustworthiness in order to attract investment.

From the abovementioned opinions of economic scholars, it could be seen that states in international treaties would have an interest to be bound through treaties that could have a certain level of constitutional

⁴⁴ A. Dixit, *The Making of Economic Policy, a transaction cost analysis* (Oxford, OUP, 1993)

⁴⁵ *ibid*

⁴⁶ Grainne de Burca and Joanne Scott Ed. *The EU and the WTO Legal and Constitutional Issues*. (Oxford: Hart publishing, 2003). P. 61

character. The level of integration depends on the structure and perspective adopted in relations with other state in a given economical political. In terms of constitutional integration, we could find two main types of cooperation: 1) Intergovernmental and 2) Federalism⁴⁷. The architecture of supranational organizations as in the European Union could be located in between the form of intergovernmental and federal.

There are two main opposing conceptions in viewing the international legal order *inter alia*: the pluralistic conception and the constitutional conception⁴⁸. The supporters of pluralistic conception posits and emphasizes the value of diversity and the difference amongst the different normative and governance systems either national or international.⁴⁹ Through the lenses of pluralist conception, politics rather than law would govern interordinal relations, with different actors and rules competing in a race to reach the authority through politics rather than legal arguments⁵⁰. In the other hand, the constitutionalist approaches such as the influential German school represented by Verdross, Simma and Tomuschat support the idea of an international legal order based on an international community and international solidarity as opposed to the concept based on separate and distinct interests of national states individually considered.⁵¹

As would be explained further, ASEAN is an international organization that encountered integration problem as almost all of the member states embracing either the pluralist approach or the soft constitutionalist view even at a regional level. In the view of Diane A Desierto, ASEAN has embraced the "thick version" of constitutionalism, which is characterized by the level of decentralization of international relations with the recognition of an international community and rights of state under international law.⁵² Compared to the European Union that

⁴⁷ Sabine Saurugger. *Théories et concepts de l'intégration européenne*. 2009. Science Po Les Presse: Paris. P. 46

⁴⁸ Luis I. Gordillo. *Interlocking Constitutions Towards an Interordinal Theory of National, European and UN Law*. Oxford: Hart Publishing, 2012. P. 297

⁴⁹ *ibid.* P. 299

⁵⁰ *ibid.*

⁵¹ *ibid.* P. 302

⁵² Melda Kamil, Lusita and Yusuf Ausiandra. *Pembangunan Bertahap Sistem Hukum ASEAN (Gradual Establishment of ASEAN Community Law System)*. Lembaga Pengkajian Hukum Internasional Universitas Indonesia (Center For International

in certain cases determined the special regime character of its regional law, ASEAN is currently still entrenched in general classical international law. Member states would eagerly solve their problems in universal or multilateral forums rather than in regional forums.⁵³

III. THE ASEAN DISPUTE SETTLEMENT STRUCTURE IN BRIEF

After thoroughly explaining the concept of economic theory of contract and specifically the theory of “incomplete contracting”, it would be further applied to deconstruct the general structure of ASEAN. The analysis of ASEAN would be limited to the mechanism of dispute resolution in ASEAN.

Historically ASEAN was firstly established in order to constitute a buffer against the growing influence of communism in Southeast Asia in the midst of the cold war⁵⁴. The regional integration stretched since 1947 where crucial tension arisen states in Southeast Asia. Three countries; Philippines, Indonesia and Malaysia decided to establish a regional organization under the name of Maphilindo which was sealed in a failure. This experience constituted a stumbling block for the formation of ASEAN on 8th of August 1967. The organizations was built upon the classical concept of sovereignty in International law embracing the principles of non-interference, consensus building, political and diplomatic peaceful settlement of disputes, respect of cultural identity, good governance and the respect of the United Nations Charter and International Law. The regional organization progressively developed co-operation and produced several important legal instruments *inter alia*:

1. *Bangkok Declaration* signed on 8 August 1967
2. *Treaty of Amity and Cooperation in Southeast Asia (TAC)*

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⁵³ This fact could be observed in cases concerning territorial disputes; member states still solve their disputes either through diplomatic stand-offs or submitting them to the jurisdiction of international courts. As an example a dispute over the Sipadan and Ligitan islands between Indonesia and Malaysia was settled under the auspices of the International Case of Justice (*I.C.J Rep. 575; 2002 I.C.J Rep. 625*). This is suprising knowing that a wide array of regional solution exist under the ASEAN treaties.

⁵⁴ Loffelholz, Martin and Damilo A. Arao, *The ASEAN Guide A Journalists Handbook to Regional Integration in Southeast Asia*, GIZ: International for Journalism, 2012, P. 38

3. *Zone of Peace, Freedom and Neutrality Declaration* (Kuala Lumpur 27 November 1971)
4. *Declaration of ASEAN Concord / Treaty of Amity and Cooperation in Southeast Asia* (Bali 24 February 1976);
5. *Declaration of Concord / Bali Concord I* (Bali, 24 February 1976);
6. *Protocol Amending the Treaty of Amity and Cooperation in Southeast Asia* (Filipina, 15 December 1987);
7. *Agreement On The Common Effective Preferential Tariff (CEPT) Scheme For The ASEAN Free Trade Area* (Singapore, 28 January 1992);
8. *Treaty on the Southeast Asia Nuclear Weapons Free Zone* (Bangkok, 1995) ;
9. Framework Agreement on Enhancing ASEAN Economic Cooperation
10. Protocol to Amend the Framework Agreement on Enhancing ASEAN Economic Cooperation
11. *Protocol to Amend The Framework Agreement On Enhancing ASEAN Economic Cooperation* (Thailand 15 December 1995);
12. Protocol on Enhanced Dispute Settlement Mechanism
13. *ASEAN Vision 2020* (Kuala Lumpur, 15 December 1997) ;
14. *Declaration of Concord / Bali Concord II* (Bali, 7 October 2003) ;
15. *Hanoi Plan of Action For 1999 to 2004 based on the ASEAN 2020 Vision*;
16. *ASEAN Charter* (Singapore, 20 November 2007) entry into force 15 December 2008.

The principle of non-interference that has been maintained until the ASEAN Charter reflects the sustained cooperation along the lines of cooperation. The maintenance of cooperation contributed to the loose and flexible organizational structure. In 2007, the ASEAN charter was signed and marked the beginning of the transformation of ASEAN from an exclusively political and diplomatic organization into a “rule-based” organization.⁵⁵ In practice, ASEAN strengthens cooperation through

⁵⁵ Melda Kamil,, Lusita and Yusuf Ausiandra. *Pembangunan Bertahap Sistem Hukum ASEAN* (Gradual Establishment of ASEAN Community Law System). *Lembaga Pengkajian Hukum Internasional Universitas Indonesia* (Center For International Law Studies). 2011-2012. P. 4

soft law and coordinative instruments, majorly through “Blue prints”.⁵⁶

The process of decision making in the ASEAN charter reflect the inter-governmental nature of ASEAN. Article 20 lays down the basic principles of ASEAN decision-making, which consists of a *premium remedium* of consultation and consensus.⁵⁷ Failure of such process or in the occurrence of a serious breach, the ASEAN Summit would hear the matters.⁵⁸ Even though considered as a fundamental process, the charter still gives an important role to the different dispute settlement mechanism contained in other ASEAN that are excluded from implementing this fundamental dispute settlement procedure.⁵⁹ Through Article 21, the ASEAN charter provides liberty to the different ASEAN Community Council to set independent rules of procedure.

The continuous reluctance of ASEAN member states to achieve higher integration is pursued also in resolution of disputes. ASEAN countries initiated cooperation in diverse sectors amongst other political and economical cooperation. Amongst the instruments stated above several embeds dispute settlement mechanism. There are four major dispute resolution mechanism in ASEAN dispersed in different legal instruments as resumed below:

General Principles	Treaty of Amity and Cooperation	Protocol on Enhanced Dispute Settlement Mechanism	ASEAN Charter
Good offices, mediation, negotiation	The formation of the high council ¹	Decision making through SEOM. This mechanism is an adoption of the WTO Dispute Settlement Mechanism	Consultation ² , Good offices, mediation, conciliation ³ , and arbitration ⁴

The Settlement of Disputes in the ASEAN Charter has been regulated under Chapter VIII of the ASEAN Charter entitled Settlement of Dispute. It consists of Articles 22 until 28.

⁵⁶ *Ibid.* P. 20

⁵⁷ Article 21 point 1 of the ASEAN Charter

⁵⁸ Article 20 point 2 and 4 of the ASEAN Charter

⁵⁹ Article 20 point 3 of the ASEAN Charter

First, there are the General Principles that are contained in Article 22, these principles advances a diplomatic and political problem of dispute settlement through dialogue, consultation and negotiation.⁶⁰ Furthermore, ASEAN maintains and pursues the construct of specifying different dispute settlement mechanism in different fields of ASEAN cooperation.⁶¹ In other words, up until the entry into force of the ASEAN charter, the member states still could not agree on unifying the settlement of disputes in different fields under one body. This results in a pluralistic dispute settlement environment.

Second, article 23 rules on the classical concept of good offices, conciliation and mediation by the ASEAN Chairman. This would be another form of political resolution to disputes approved by the members through the Charter.

Third, there are the dispute settlement mechanisms contained in the specific instruments. They each apply for different fields regulated under different legal instruments.⁶² A problem arises when in matters of interpretation is referred to the ASEAN Protocol on Enhanced Dispute Settlement Mechanism while problems excluded from matters of interpretation of ASEAN instruments would be relegated to the Treaty of Amity and Cooperation.⁶³

Fourth, there are the additional mechanism including arbitration on disputes arising over the interpretation and application of the ASEAN Charter.⁶⁴ Yet, the *ultimum remedium* would be conveyed to the ASEAN Summit for persistent unresolved dispute.⁶⁵

Finally, the ASEAN Charter contains a bridging article that permits member states to apply modes of peaceful settlement contained in Article 33 (1) of the United Nations Charter or any other international legal instruments.⁶⁶

We could observe that there are potential conflicts arising from the open-ended and pluralistic and multi-layered environment. There are

⁶⁰ Article 22 point 1 of the ASEAN Charter

⁶¹ Article 22 point 2 of the ASEAN Charter

⁶² Article 24 point 1 of the ASEAN Charter

⁶³ Article 24 point 3 and point 2 of the ASEAN Charter

⁶⁴ Article 25 of the ASEAN Charter

⁶⁵ Article 26 of the ASEAN Charter

⁶⁶ Article 28 of the ASEAN Charter

in principle four types of dispute resolution mechanism but the scopes of each are integrally mentioned in the ASEAN Charter. Subsequently, dispute would be resolved in accordance with the protocol to the ASEAN Charter on Dispute Settlement Mechanism 2010.⁶⁷ Even in the hypothetical case that a dispute has been resolved through an ASEAN dispute settlement procedure, non-compliance would still be decided at the ASEAN Summit, which once more be a political, and diplomatically forum⁶⁸.

Furthermore, amongst the different mechanism, non have actually resulted in a resolution. The only case that has been brought without continuation was an investment case between *Yaung Chi Oo Trading Pte Ltd* against *The Government of Myanmar Union*. The arbitration court set-up by ASEAN ruled out non-jurisdiction of the basis of avoiding unnecessary disputes amongst ASEAN member states.⁶⁹ The continuous political approach to issues, the maintenance of the non-interference principle has hindered further integration of the regional organization.⁷⁰ To the xtend that dispute settlement in ASEAN would be legalized it would eventually end in a political resolution as far as the ASEAN legal instruments are concerned *in casu* at the ASEAN Summit.

IV. ANALYSIS: INCOMPLETE CONTRACTING AND INTEGRATION

Incomplete contracting permitted to comprehend the construction of a treaty through the lenses of law and economics. The goal of treaty

⁶⁷ Melda Kamil, Lusita and Yusuf Ausiandra. *Pembangunan Bertahap Sistem Hukum ASEAN* (Gradual Establishment of ASEAN Community Law System). *Lembaga Pengkajian Hukum Internasional Universitas Indonesia* (Center For International Law Studies). 2011-2012. P. 81

⁶⁸ Rule 1 Annex 6 Rules of Reference for non compliance to the 2012 ASEAN Summit Instrument of Incorporation of the Rules for reference of non compliance to the ASEAN Summit to the Protocol to the ASEAN Charter on Dispute Settlement Mechanism.

⁶⁹ Lin Chun Hung, "Development and History, ASEAN Charter: Deeper Regional Integration under International Law", *Chinese Journal of International Law*, December 2010, p. 11.

⁷⁰ Melda Kamil, Lusita and Yusuf Ausiandra. *Pembangunan Bertahap Sistem Hukum ASEAN* (Gradual Establishment of ASEAN Community Law System). *Lembaga Pengkajian Hukum Internasional Universitas Indonesia* (Center for International Law Studies). 2011-2012. P. 18

contracting as explained before was to maximize joint welfare until reaching the level of Pareto efficiency. This would take the form of a CCC or complete contingency contract. Due to transaction costs, the attempt to draft this type of contract would outweigh the benefit of the action. The lack of knowledge on future events combined with the desire to preserving policy space by also adopting "*strategic ambiguity*" in the formulation of an incomplete contract.⁷¹ Subsequently, treaties have been drafted in the form of an incomplete contract. This takes form in clauses drafted with an open-ended language. Strategies of dealing with the incompleteness of the contract could be distinguished into two types namely deliberately embracing incompleteness or striving towards completeness.

As could be seen with the case in ASEAN, states are still mostly under the perspective of classical international law with exceptions such as in the European Union, which has a tendency to strive towards supranationalism.⁷² In view of this legal and political environment, while participating in cooperation with other states under various international organizations, a general preference of preserving policy space still prevails. In accordance with this fact, states would prefer the drafting of international treaties under the trajectory of embracing incompleteness. By adopting this option, states could continuously obtain the benefit of a maximized joint cooperation while maintaining an important level of policy space. This trajectory of incompleteness would induce the use of courts as "gap-fillers" to complete the treaty by interpretation of the open-ended clauses of the treaty. This logical flow would result into the proposition that in order to make open-ended treaty language enforceable, an authoritative adjudicative body would be necessary to "fill the gaps" of the incomplete treaty.

In applying the incomplete contracting theory, we could distinguish that there is a Type A or efficient incompleteness in the formulation of Articles of Chapter VIII on Dispute Settlement of the ASEAN Charter. As explained before a Type A or efficient incompleteness occurs when parties would willingly draft an incomplete contracting under the light

⁷¹ B. Douglas Bernheim and Michael D. Whinston. "Incomplete Contracts and Strategic Ambiguity". *The American Economic Review*. vol. 88, no. 4, September 1998. p. 904.

⁷² *Op. Cit.* P. 21

of symmetrically revealed contingencies due to constraints provoked by transaction costs that out-weight the benefit of identifying, enumerating and drafting all the possible contingencies. Efficient incompleteness could also be an option whenever efficient responses to contingencies are at a minimum variation yet non-specifiable beforehand. The member states were willingly preserving the dispute settlement mechanism that exists in all previous and future instruments.⁷³ This results in a diversified disputes settlement mechanism that results in an ambivalent treaty language – a typical result of incompleteness - that undermines the efficiency of the overall ASEAN dispute settlement mechanism. The member states approached each different instrument based on the symmetrical information existing that is continuously subject to variations.

Through the experience of ASEAN member states, it could be demonstrated that member states embrace incompleteness and focus on identifying contingencies and preserving policy space through loose or coordinative cooperation. But, problem arises with the absence of a centralized authoritative body to rectify and complete the treaties. By authoritative body, it would be inferred that a legally authoritative body. The ASEAN legal system ultimately reserves dispute settlement through political approaches in the ASEAN Summit. This hinders predictability, certainty and the potential of achieving an optimized cooperation and deters further integration. Hence it could be inferred that in the framework of incomplete treaty drafting and the strive towards the preservation of policy space, a centralized authoritative body should be appointed as “gap-fillers” to complete the given treaty. In addition, the adoption of a more comprehensive drafting language by amending the error of “insufficient language” in the ASEAN charter and other instruments could ameliorate the ASEAN treaties towards completeness.

The absence of a centralized legal authority combined with an open-ended and over-flexible treaty language containing tremendous exceptions to mandatory rules would leave the treaty in its incomplete state. The treaties would thus be ineffective, open to opportunistic behavior and legally quasi inexistent. ASEAN has progressed towards a rule-based organization and considering further integration especially in regional liberalization of the economy. But the absence of a single authoritative body in ASEAN and a large amount of diplomatic based

⁷³ Article 24 (1) ASEAN Charter

dispute resolution bring down ASEAN once more to a mere political and diplomatic cooperation. ASEAN would have a greater potential in reaching a higher level of constitutionalism at a regional level and this could be achieved through the completion of the treaties with a single authoritative body.

V. CONCLUSION AND RECOMMENDATION

In sum, the progressive application of interdisciplinary approaches to international law has permitted the comprehension of the role of third party adjudicative in relation with the enforcement of entitlements of treaties. The joint maximization of welfare that could be translated into the Pareto efficient concept in economics of contract law as the meeting point, the drafting of treaties would have the same goals. Furthermore, state actors prefer further integrative cooperation rather than decentralized cooperation due to the Pareto inefficient nature of non-cooperation that could be solved through treaty drafting and repeating actions founded through reciprocity. This infers that the parties to a treaty would be inclined to obtain to extend possible benefits from the contracts. Incomplete contracting permits to understand the impossibility of drafting complete contingency contracts or CCC and the strategy of using third party adjudicative as "gap-fillers". The efficiency of this approach could be seen in international cooperation and unions such as in the World Trade Organization, NAFTA and the European Union. At the contrary the open-ended treaty language applied in the ASEAN treaties and the ASEAN Charter combined with huge sparse array of multiple alternative disputes with an ultimate resolution by diplomatic means resulted into the stagnation of ASEAN as only a coordinative progress with low levels of possible future integration. Reliance on coordinative soft law such as blue prints and the constant reference to external international law regimes such as WTO and ICJ further undermines the effectiveness of the ASEAN regional treaties.

As a recommendation, through this essay, I would propose the unification of dispute settlement mechanism under the jurisdiction of one authoritative "roof" that would be bestowed upon an appointed regional court or arbitration. This could be achieved through an amendment of the ASEAN Charter and the harmonization of the treaties respectively

containing different dispute settlement mechanism. By adopting the theoretical proposition above, the contract would be potentially more cohesive and the cooperation would probably grow into a further Pareto efficient integration.

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