U.S. politicians adhere to balanced budget rules because they fear the bond markets, not judicial intervention.

In the wake of the European financial crisis, European Union (EU) leaders have reformed Eurozone governance to empower national and EU courts to enforce deficit and debt limits. In designing these reforms, policymakers drew lessons on balanced budget rules in U.S. states. But is the threat of court enforcement actually effective in ensuring balanced budgets in the states? In new research, **R. Daniel Kelemen** *and* **Terence Teo** *find that despite their 170-year history, these judicial mechanisms are almost never enforced in court, and that they do not act as a deterrent to breaking budget rules for state officials. They argue instead, that clear balanced budget rules can act as a 'red line' for investors and bond markets, which, if broken, will act as a signal for them to punish sovereigns.*

A central concern in the design of Eurozone governance – both when the system was established in the 1990s and when it was reformed in the wake of the sovereign debt crisis – was how to discourage excessive borrowing by states. In approaching this question, many analysts have drawn lessons for the Eurozone from the literature on balanced budget rules in U.S. states. While there is some disagreement in this literature, the preponderance of empirical studies suggest that state balanced budget rules can in fact limit state deficits and reduce state borrowing costs and that these rules work better the stricter they are. In particular, many scholars have emphasized that the key to the effectiveness of balanced budget rules is the strength of the judicial enforcement mechanisms backing them up.

This perspective has influenced the approach European Union (EU) leaders have taken to reforming Eurozone governance in the wake of the sovereign debt crisis. EU leaders have emphasized empowering national and EU courts to enforce deficit and debt limits, even more so than was the case under the earlier Maastricht Treaty-based regime for Eurozone governance. For instance, the 2012 Fiscal Compact Treaty requires all Eurozone states and other ratifying states to enshrine a balanced budget rule into domestic law where it can be enforced by domestic courts.

But the literature on US balanced budget rules and the EU leaders who have drawn lessons from it ignore a curious historical fact: state balanced budget rules in the U.S. have almost never been enforced in court. Such rules have been in place since the 1840s, but the first case in which a court held that a state had failed to balance its budget as required under a state constitution's balanced budget rule came only in 2004. In short, the literature suggests that judicial enforcement mechanisms are key to the effectiveness of balanced budget rules, yet these rules are never actually enforced in court. How can this be the case? Why does it seem that public officials generally adhere to rules which are never enforced in court? Some scholars explain away this puzzle with a legal deterrence logic: the very threat that violation of balanced budget rules could lead to judicial enforcement is sufficient to deter lawmakers from breaking the rules in the first place.

This logic is unconvincing. We see little reason that politicians should be particularly afraid of seeing their budget decisions challenged in court and leaving it to the courts to enforce balanced budget rules. We argue that where politicians adhere to balanced budget rules they do so not due to fear of judicial intervention, but due to fear of the bond markets.

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Where balanced budget rules are sufficiently clear, they present a "red line," the crossing of which would be evident to all investors and which all would expect to generate a market reaction. In other words, clear balanced budget rules create a focal point that generates a shared expectation among investors of the point at which they will demand higher yields. Eager to avoid this coordinated market punishment, sovereigns will seek to avoid violating clear balanced budget rules in the first place.

If this logic of decentralized market punishment is correct, then the clarity of balanced budget rules – not the strength of their judicial enforcement mechanisms, should be the key to their effectiveness. In our recent empirical analysis of US state balanced budget rules, we provide strong evidence in support of our perspective – evidence which calls into question a number of previous studies which had pointed to the importance of strict legal enforcement mechanisms.

Our analysis and findings on the US suggest that EU's effort to judicialize fiscal policy through balanced budget provisions of the Fiscal Compact Treaty is unlikely to succeed. The EU's approach seems to be based on the dominant – but in our view incorrect – understanding of how balanced budget rules can work to constrain sovereign debt. The EU has emphasized putting in place strict legal mechanisms to enforce its balanced budget rules, while it has left the rules themselves highly ambiguous. From our perspective, this approach is sure to fail.

The EU's emphasis on legal enforceability is misplaced because it is not courts, but bond markets that may actually enforce balanced budget rules. But bond markets can only play this disciplining role effectively where balanced budget rules have sufficient clarity to provide a focal point that enables investors to coordinate on when to punish governments for running excessive deficits. And if there is one thing that the EU's balanced budget rules lack, it is clarity.

The Fiscal Compact Treaty requires states to maintain "structurally balanced" budgets, which are balanced across the business cycle and the treaty allows violations of this rule in a variety of "exceptional circumstances". It is far from clear what exactly constitutes a cyclically adjusted, structurally balanced budget or what might constitute "exceptional" circumstances. Therefore, just what constitutes a violation of the EU's balanced budget rules will be subject to lengthy debates. This flexibility may be necessary to allow states to engage in countercyclical policies during economic downturns, but it also means that these vague rules do not provide the sort of clear focal points that could coordinate decentralized punishment by bond markets – or could prevent excessive sovereign borrowing in the first place.

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