ECONOMY

High interest rates boost state savings

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The Federal Reserve building in Washington. (AP Photo/Patrick Semansky)

States are earning hundreds of millions of extra dollars in interest on cash holdings and short-term investments as the Federal Reserve raises interest rates.

The states' interest earnings are small relative to their overall spending. But the additional money could still help cover the rising cost of government services, state officials and public finance experts say.

"In the short term, this is helping states and cities keep their budgets in balance," said William Glasgall, senior director, public finance at the Volcker Alliance, a New York-based nonprofit that supports public sector workers.

It is the first time in over a decade that state and local governments have earned a significant return on cash and very short-term investments such as Treasury bonds and money market funds. For many states, the earnings jump last year was the largest in a generation.

Illinois earned $407 million in interest on general fund balances in fiscal 2023, more than 13 times the amount earned the year before.

"This is by far the biggest year we've had, going back at least 30 years," said Benjamin Varner, chief economist for the Commission on Government Forecasting and Accountability, a nonpartisan agency that advises the Illinois legislature.

Federal Reserve leaders began rapidly raising rates last spring in an attempt to slow economic growth and bring down inflation. The federal funds effective rate, which is the rate banks charge when they lend to each other, is now about 5.08%, the highest it's been since 2007.

During and after the Great Recession, from about 2008 to 2016, the Federal Reserve held rates below 1% in an effort to spur economic growth. Central bankers raised rates from 2016 to 2019, then dropped them steeply when the Covid-19 pandemic hit.

States are now earning a little more than 5% on cash holdings and very short-term investments, Glasgall said. A decade ago, they were earning almost nothing.

While state revenues boomed in recent years, lawmakers were stashing record sums in rainy-day funds and reserve accounts. States and cities held about $9.3 trillion in cash and securities in 2021, according to federal Census data.

"If you've got $1 billion in cash sitting around, all of a sudden, now you're earning real money," Glasgall said.

Illinois earned more in interest last year in part because it has more money in the bank, Varner said. The state's rainy-day fund, for instance, now holds about $2 billion, a record amount.

Interest earnings increased dramatically in many states last fiscal year. Massachusetts earned $502 million, about 10 times the amount earned in fiscal 2022. Texas earned an estimated $2.62 billion, over eight times the amount earned in fiscal 2022, and Kansas earned $244 million, about 27 times the amount earned in fiscal 2022. Most states ended fiscal 2023 on June 30.

Kansas and localities that pool funds with the state could collectively earn more than $400 million in interest this fiscal year, said state Treasurer Steve Johnson (R).

"There are many objectives that can be achieved [with the money] that we hadn't necessarily planned for three years ago," Johnson said. "That's real revenue."

Johnson, a former state lawmaker who chaired the House Taxation committee, said he doesn't expect short-term interest rates to remain this high forever.

Lawmakers should base tax and spending decisions on ongoing revenues, not a short-term bump in interest earnings, he said. "It's a great opportunity to tackle one-time projects, it's a great time to address liabilities, fix the balance sheet."

Glasgall said there is a fiscal downside to high interest rates: They have made it more expensive for states and cities to borrow money. And if central bankers raise rates too high and trigger a recession, states could face plunging tax collections and budget problems.

"If rising interest rates stay high long enough to really slow the economy," Glasgall said, "it's going to have an impact on tax revenues."