Institutions and State Spending
An Overview

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Research Findings

• Across the country, state policymakers and their constituents are looking for ways to reduce spending as states face unsustainable long-term budget outlooks. While item-by-item budget cuts can reduce spending in any particular year, future policymakers can always undo these cuts.

• Lasting change is better achieved by changing the rules of the game that shape the budget process. The following institutions have demonstrably reduced per capita spending across states that have implemented reforms.

• In addition to the reforms shown in the chart above, baseline budgeting (as opposed to current services budgeting) and citizen legislatures (where serving as a legislator is not a full-time job) have also been shown to reduce spending.

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Nebraska’s Institutional Landscape

• While Nebraska already operates under some of the institutions found to limit state spending, several institutional changes could help the state further rein in expenditures. Requiring a legislative “supermajority” for any tax increases, moving from two-year budgets to annual budgets, and enacting strict tax and expenditure limits could all save money for Nebraska taxpayers.

| Item Reduction Veto | ✓ |
| Line Item Veto | ✓ |
| Strict Balanced Budget Requirement | ✓ |
| Lack of Automatic Shutdown Provision | ✓ |
| Centralized Spending Committees | ✓ |
| Separate Spending and Tax Committees | ✓ |
| Tax and Expenditure Limit | ✗ |
| Annual Session for Annual Budget | ✗ |
| Supermajority Requirement for Tax Increases | ✗ |
| Strict Rules Govern State Rainy Day Fund | ✗ |
| Senate Seats: 49 (34,924 ppl per senator) | Rank 43/50 states |
| Ratio of House to Senate Seats (Nebraska is the only U.S. state with a unicameral legislature) | n/a |

• Changing state law to require a legislative “supermajority” to pass any tax increase is the institutional reform with the highest potential for savings in Nebraska. Currently 15 states have such requirements, and these requirements are associated with significantly lower per capita spending levels. States with these rules spend, on average, $151 less per capita.

• Modifying Nebraska’s budgeting process so that budget cycles last one year instead of two could also potentially save taxpayer money.

• Currently Nebraska does not have either a tax or an expenditure limit. Implementing a rule that ties the growth of state spending to inflation plus population growth would be a strong step toward more sustainable fiscal policy.
Abstract

U.S. fiscal policy at the federal, state, and local level is on an unsustainable path. While reformers should look for ways to reduce spending on particular budget items, tomorrow’s legislatures may easily reverse these cuts. In contrast, a change in the rules that govern the political process—the “institutions” that shape a budget—can have a lasting effect on spending for years to come. Codified in statutes and constitutions, these institutions include the rules of budgeting, electioneering, and legislating. They influence the decisions of legislators, governors, presidents, bureaucrats, voters, and even lobbyists. As such, institutional reform can be a more effective and sustainable path to fiscal probity than a one-time budget cut. This paper summarizes the empirical investigations of sixteen state-level institutions. The lesson for both state and federal policy makers is that there are a number of institutional reforms that seem likely to put spending on a more sustainable path.

Introduction

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Justice Brandeis famously referred to the federal system as a “laboratory” in which each state was free to implement novel social and economic experiments. For the social scientist interested in understanding how institutions affect policy outcomes, the metaphor is apt. Each of the 50 states has its own set of institutions and some of these have changed over the course of the last several decades. At the same time, many other factors that might influence outcomes are invariant across the states. In other words, cross-state studies effectively control for factors such as macroeconomic conditions, culture, and the broad legal/constitutional setting in which each state operates. Moreover, researchers are able to employ various econometric techniques to control for the influence of those factors that are different across states such as climate or demography. In sum, the setting provides a rich laboratory in which to test the effect of different institutions on spending.

A large number of researchers have performed these tests and this paper reviews this literature, summarizing the
Sixteen Institutions and Their Effects on State Spending

1. Strict Balanced Budget Requirements

With the exception of Vermont, every state has a balanced budget requirement, but the stringency of these requirements varies widely. For example, in some states, the governor must submit a balanced budget, but the legislature need not pass one. In other states, estimates of the enacted budget need to show balance, but there are no consequences if these estimates prove wrong at the end of the fiscal year and the actual budget is out-of-balance. In some states, the legislature may carry-over a deficit from one year to the next, while in others they may not. Lastly, in some states an independently elected Supreme Court is the ultimate enforcer of the requirement, while in others the legislature appoints the members of the Supreme Court.

Even though balanced budget requirements are designed to ensure only that spending be less than revenue, there is reason to believe these requirements may reduce both spending and revenue. The Nobel laureate James Buchanan and his coauthor Richard Wagner explained why this might be when they observed that the ability to buy items for current voters while leaving future voters to pick up the tab systematically biases policy in favor of greater spending. 7

Indeed, a number of studies have found that states with stricter balanced budget requirements tend to tax and spend less than other states. Henning Bohn of U.C. Santa Barbara and Robert Inman of the University of Pennsylvania, for example, find that per capita spending is about $189 less in states with strict balanced budget requirements relative to those with only weak requirements. 8 David Primo of the University of Rochester arrives at a remarkably similar result, finding that strict balanced budget requirements reduce per capita spending by about $184 per capita. 9 If this is the impact of moving from a weak to a strict balanced budget requirement, it is possible that if the federal government were to adopt a balanced budget requirement where none now exists then the impact would be even greater.

Strict balanced budget requirements have other salubrious effects. Bohn and Inman also find that states with strict requirements tend to have larger rainy day funds and larger surpluses and that states with these requirements tend to balance their books through spending reductions rather than...
revenue increases. Shanna Rose of New York University finds that states without strict balanced budget requirements are more likely to suffer from a “political business cycle” whereby policymakers increase spending just prior to an election, only to cut back following the election.\(^\text{10}\)

But there may be some unintended consequences of a strict balanced budget requirement. Economists Noel Johnson, Matthew Mitchell, and Steven Yamaria recently concluded that while such rules limit the likelihood of partisan fiscal outcomes, they increase the likelihood of partisan regulatory outcomes. When Democratic-controlled states were unable to carry a deficit forward to the next fiscal cycle, they were more likely to raise the minimum wage, less likely to adopt a right-to-work statute, and more likely to regulate personal freedoms.\(^\text{11}\)

2. State Rainy Day Funds

Some commentators worry that a balanced budget requirement exacerbates the ups and downs of the business cycle. Since state budgets tend to be the tightest at the bottom of an economic downturn, this argument goes, strict balanced budget requirements force states to cut back on spending at the worst time.\(^\text{12}\) One institutional answer to this critique is a “budget stabilization fund,” better known as a rainy day fund. States contribute to these funds during good years and then draw on them when the budget is strained due to a downturn or some other event such as a natural disaster. Forty-seven states currently maintain such funds, but like many institutions, their design varies on a state-by-state basis.\(^\text{13}\)

Studies of rainy day funds suggest that they can smooth out the spending cycle, but the details matter. Gary Wagner of Duquesne University and Erick Elder of the University of Arkansas conducted the most-comprehensive recent study of rainy day funds. They find that states whose rainy day funds have strict rules governing deposits and withdrawals tend to experience a $14 per capita reduction in spending volatility (as measured by the cyclical variability of per capita spending over time).\(^\text{14}\)

3. Supermajority Requirements for Tax Increases

Fifteen states require supermajority votes of the state legislature to raise taxes.\(^\text{15}\) Depending on the state, these rules require two-thirds, three-fourths, or three-fifths of the legislature to consent to a tax increase. In some states, the supermajority requirement applies to all taxes and in others it applies to a subset of taxes. A number of researchers have found that these rules reduce spending. Economists Mark Crain and James Miller III, for example, find that states with supermajority requirements for tax increases tend to increase spending at a slower pace.\(^\text{16}\) A subsequent study by Brian Knight of Brown University finds that the effective tax rate in states with these requirements is between 8 and 23 percentage points lower than in states without such a requirement.\(^\text{17}\) The latest and most-comprehensive studies suggest that these requirements are associated with significantly lower per capita spending levels. Crain, for example, finds that states with these rules spend, on average, $151 less per capita.\(^\text{18}\) Similarly, economists Timothy Besley and Anne Case find that these rules reduce per capita spending by $103.\(^\text{19}\)

4. Tax and Expenditure Limits

In the last several decades, a number of states have experimented with formal rules that are specifically designed to arrest the rate of growth of government. These so-called “tax and expenditure limits” (TEls) are either codified in the statutes or constitutions of 28 states.\(^\text{20}\) The rules bind state spending, taxation, or both through formulas that reference factors such as the personal income of state residents, population growth, the inflation rate, or some combination thereof.

Early studies of these rules concluded that they generally fail to restrain the fiscal growth of government.\(^\text{21}\) Newer studies, though, use larger and more detailed data sets and tend to find that these institutions can be effective in certain circumstances.\(^\text{22}\) As with balanced budget requirements and rainy day funds, however, the details matter.

A number of studies, noting that TEL formulas are often based on residents’ incomes, examine whether TELs have different effects in high versus low-income states. Crain, for example, finds that TELs in low-income states seem to reduce spending by about $114 per capita while TELs in high-income states seem to increase spending by about $534 per capita.\(^\text{23}\)

Other studies have focused on the fact that the details of TEL laws vary considerably from state to state. These, too, have tended to conclude that TELs can effectively restrain spending, but only in certain circumstances. Mitchell, for example, found that TELs are more effective when their formula is based on the sum of inflation plus population growth, when they bind spending rather than revenue,
when they require a supermajority rather than a simple majority vote to be overridden, when they immediately refund revenue collected in excess of the limit, and when they prohibit unfunded mandates on local governments.  

5. Line-item Vetoes

Like the president of the United States, every governor in the union possesses a veto power. In addition to the simple veto, however, 44 governors possess a “line-item veto.” This allows them to strike specific sections from a bill.  

At the federal level, a statutory line-item veto was approved by both houses of the Congress and signed by President Clinton in 1996. In 1998, however, the Supreme Court struck down the law. Now, a federal line item veto would either require constitutional amendment, or a carefully-worded statute that ensured the legislative branch retained the final say on the matter.

Early studies of the line-item veto at the state level found that it had no impact on overall state spending. Subsequent research, however, has focused on the impact of the line-item veto in times and places where different parties control the governor’s mansion and the legislature. This line of research has found that the line-item veto can have a large and statistically significant impact on per capita spending. Besley and Case, for example, find that in a state with a divided government the line-item veto reduces per capita spending by about $100.

6. Item-reduction Vetoes

In most cases, when a governor possesses a line-item veto, he must completely defund any budget items he wishes to strike. In twelve states, however, the governor need not zero-out the entire item. Instead, he may write in a lower amount. In such cases, the governor is said to possess an “item-reduction veto.” Theoretically, an item-reduction veto changes the negotiating power between the governor and the legislature by effectively denying the legislature the ability to make the governor a take-it-or-leave-it offer. Mark Crain estimates that this particular variety of veto seems to have a substantial effect on spending, lowering per capita expenditures by $471.

7. Baseline Budgeting

States tend to use one of two different “baselines” when they consider a new budget. On the one hand, they may take the dollars spent in the previous year as the baseline. On the other hand, they may take the level of services that those dollars bought as the baseline. If they take the second approach, then price increases in services are automatically incorporated into the budgetary baseline. A study by economists Mark Crain and Nicole Crain suggests that spending grows about half a percentage point slower in those states that use dollars spent rather than services rendered as the baseline.

8. No Automatic Shutdown Provision

In twenty-two states, the government automatically shuts down if, by the beginning of the fiscal year, policy makers have not reached an agreement on the budget. A similar rule applies to the federal budget. David Primo explains the theoretical effect of an automatic shutdown provision:

The legislature has the bargaining advantage because the governor, when considering a spending proposal, compares it to the outcome that would be obtained if he vetoed the spending proposal.

Under these circumstances, “the legislature will be able to achieve its ideal budget, so long as the governor prefers it to no spending.” In other words, the threat of a shutdown essentially permits the legislature to make a take-it-or-leave-it offer and that is enough to make the governor concede to their spending demands.

Empirical analysis seems to corroborate this theory. According to Primo, states without an automatic shutdown provision spend about $80 less per capita.

9. Separate Spending and Taxing Committees

Some states allow one legislative committee to have jurisdiction over both spending and taxing legislation. Others divide the two powers between separate committees. Intuitively, those states that keep these functions separate seem likely to spend less than those that combine them. The idea is essentially Madisonian: if one committee has jurisdiction over taxing but not spending then its members—unable to steer spending projects towards their constitutions—will have an incentive to block the interests of other committees with spending authority.

The last researchers to publish on this matter were Mark Crain and Timothy Muris. According to their data (which is from the 1980s), five states combine spending and taxing authority in one committee while the rest keep these two functions separate. They find that states with combined
spending and revenue authority tend to spend $1,241 more per capita than states with separate authorities. As indicated by Figure 1, this is by far the largest per capita effect of the institutions this paper surveys.

10. Centralized Spending Committees

Researchers have also examined the effect of centralizing spending authority in one committee rather than dividing it among several separate spending committees. In this case, the theoretical prediction is different: when a number of different committees have a hand in determining spending priorities, spending is subject to a “tragedy of the commons.” As Crain and Muris put it:

[N]o one committee has the incentive to restrain its spending commitments because the total level of spending is no longer the responsibility of any one committee. To the contrary, the resulting competition among committees to spend results in more spending than would otherwise occur, increasing reliance on deficit financing.41

John Cogan of the Hoover Institution and Stanford University examines this question at the federal level and finds that during periods in which the U.S. Congress had decentralized spending authority, spending grew much faster than in other periods.42

At the state level, Crain and Muris find that in the 1980s, 24 states had centralized spending authority in one committee, while the rest had spread it out among several committees. Their results corroborate the federal study by Cogan. They find that, on a per capita basis, states with centralized spending authority spend about $199 less than those with decentralized spending authority.43

11. Annual Budgeting

Some state budget cycles last one year while others last two. Given the large number of complex projects that governments currently fund, biennial budgeting would seem to afford legislators the time to carefully scrutinize the budget in order to properly weigh the costs and benefits of different programs.

Indeed, Crain notes:

Since 1977 a number of proposals have been introduced in the U.S. House and Senate to lengthen the federal budget cycle from an annual to a biennial process. The perception behind these proposals is that a federal biennial budget would help curtail the growth of federal expenditures.44

But the theoretical relationship is not so clear. According to Paula Kearns of Michigan State University, a biennial budget might on the one hand shift the balance of power from the legislature to the governor. Since governors cannot export the costs of spending to other districts as legislators can, she reasons that this might lead to less spending. On the other hand, she notes that biennial budgeting introduces a measure of durability, which may make it more appealing for special interest groups to lobby for government largesse, thereby increasing spending.45

Kearns’s empirical investigation supports the second hypothesis: a biennial budget cycle seems to increase spending.46 Crain corroborates this result, finding that states with annual budgets tend to spend about $119 less per capita than states with biennial budget cycles.47

12. Small Senates

A number of researchers have examined whether the size of a legislative chamber affects spending. The expectation has tended to be that larger chambers will spend more because each member has an incentive to spend in his or her own district while spreading the cost among all districts, and as the number of cost-sharing districts increases this incentive grows stronger.48

A number of researchers, using data at both the city and the national level, have found that larger unicameral legislatures do tend to spend more.49 In bicameral legislatures, however, the more-seats-more-spending relationship holds in the upper house only. For example, Thomas Gilligan and John Matsusaka of the University of Southern California find that the number of state House seats has little or no effect on spending, but the number of Senate seats does. State Senates range from 21 to 67 members, and they find that a one-seat increase in membership is, on average, associated with about $17 more in per capita spending.50

13. Large House-to-Senate Ratios

Why does the size of the House not affect spending? Jowie Chen, now of the University of Michigan, and Neil Malhot of Stanford University offer one reason. They observe that “lower chamber districts, at least in the United States, are
unique because they are geographically embedded within Senate districts.”

Thus:

[D]ividing each Senate district into more House districts has the effect of shrinking each House member’s constituency, *ceteris paribus*. Having a smaller constituency dilutes House members’ payoffs from exploiting common pool resources to fund large pork barrel projects.

This means that adding more House seats should not have an affect per se, but increasing the ratio of House-to-Senate seats *should* lead to less spending. They corroborate this theoretical prediction with empirical analysis estimating that decreasing the Senate size by one seat can lower per capita spending by almost $6, while increasing the House-to-Senate seat ratio by one unit decreases per capita spending by about $45.

14. “Citizen” Legislatures

In some states, legislating is a full-time job. Legislators work year-round, have large professional staffs, and are paid salaries that make outside work unnecessary. In other states, however, the legislative session is short, staffs are small, and legislators are paid too little to make legislating their only means of employment. The theoretical impact of a “professional” versus “citizen” legislature is unclear. A citizen legislator who spends most of his time outside of the capitol building might be more susceptible to the persuasions of interest groups than a professional who gets his information from paid staffers. On the other hand, citizen legislators, because they have other jobs, might not need the legislative job security that comes with appeasing interest groups.

Economists Stephanie Owings-Edwards and Rainald Borck examine this question with an “index of professionalization” which includes factors such as legislative compensation, staff expenditure, and the length of legislative sessions. They find that a one-standard-deviation increase in professionalization increases spending by about 10.2 percent.

15. Direct Democracy

In the late 19th century, a number of states began experimenting with direct democracy by permitting their citizens to directly vote on legislation in statewide ballots. Today, 27 states permit this sort of direct democracy in one form or another.

Early studies of direct democracy at the state level concluded that it either had little effect on spending or that it boosted spending. More recent studies that use larger data sets tend to find the opposite effect. For example, Matsusaka finds that an initiative with a 5-percent signature threshold (the most common threshold) is associated with per capita spending that is $1.36 lower. The economists Dale Bails and Margie Tieslau arrive at a similar result, concluding that the initiative tends to decrease per capita spending by about $158.

More recently, however, Besley and Case, ran a series of regressions and found that in most of them, the initiative had little impact on spending. Matsusaka has suggested one way to reconcile all of these findings. He argues that the effect of direct democracy switched at some point in the last several decades, and that direct democracy was associated with more spending in the early part of the 20th century and less spending in recent decades. This may be the result of changing public attitudes toward spending.

16. Term Limits

Does limiting the time a politician can spend in office affect spending? Some proponents of term limits have argued that they break-up the political culture of spending. But not everyone agrees. Some researchers make the case that term limits remove an important check on politicians by freeing them from the necessity of seeking voter approval in their final terms.

The empirical investigations of term limits have not clarified matters. Consistent with the view that term limits lead to more spending, Besley and Case find that Democratic governors tend to spend more in their second terms when they cannot run again. Using a larger dataset, they recently reexamined the question and observe an odd pattern. Like direct democracy, the effect of gubernatorial term limits seems to have changed over time. They conclude that gubernatorial term limits lead to more spending in the 1950s, 1960s, and early 1970s, but seem to be associated with less spending from the mid-1970s onward. Unfortunately, they write, “We can offer no simple explanation for this pattern.”

The effects of legislative term limits are no clearer. In their 2000 study, Bails and Tieslau find that legislative term limits reduce per capita spending by about $173. But a more
recent study by the political scientist, Abbie Erler, finds that states with more restrictive legislative term limits actually spend about $212 more per capita than others. In sum, it seems that the evidence on term limits is decidedly mixed.

Conclusion

Absent policy change, governments at all levels—and those who have come to depend upon them—face a bleak future. According to projections, both federal and state spending growth is unsustainable, threatening to push debt-to-GDP ratios well past 90 percent in a matter of decades. The 90-percent mark is important because that is when research suggests that debt begins to hamper economic growth.

A handful of policies seem to be driving the problem: Medicaid, pensions, and other post-employee benefits loom large. But these policies—are all policies—are themselves the products of the institutions that helped create them, the rules that influence political outcomes at the state level. These institutions and their impact on spending have been the subject of extensive study. This paper reviews this research and highlight more than a dozen institutions that have been shown to limit spending, limit the growth of spending, or limit the volatility of spending.

After converting all per capita estimates into 2008 dollars, it is clear that separate taxing and spending committees and item reduction vetoes have the largest effect on per capita spending. These institutions also happen to be among the least-studied and so further analysis may be warranted. Among the most-studied of the institutions are strict balanced budget requirements, supermajority requirements for tax increases, and tax and expenditure limits.

In many cases, subsequent study of institutions has yielded more nuanced results. For example, a number of the institutions this paper discusses are only effective in certain circumstances or when they are designed in a certain way. This suggests that we may still have much to learn about the institutions and that the evidence on item reduction vetoes. Nevertheless, policy makers interested in arresting the unsustainable growth of government seem to have a number of tools at their disposal.

Endnotes

1 We thank Meg Patrick for excellent research assistance and Jennifer Zambone and Emma Elliott for superb editorial improvements.


3 The Nobel Laureate Douglass North is often considered the father of modern institutional economics. In his terms, institutions “are the humanly devised constraints that shape human interaction.” Douglass North, Institutions, Institutional Change and Economic Performance (New York: Cambridge University Press, 1990).


5 Though this paper focuses on the effect of institutions on spending, there is a larger literature focusing on the effect of institutions on a wide variety of policy outcomes. For a review of this larger literature, see Timothy Besley and Anne Case, “Political Institutions and Policy Choices: Evidence from the United States,” Journal of Economic Literature, Vol. 41, No. 1 (March, 2003), 7-73, http://www.jstor.org/psav/3217387.


8 This estimate, like all others reported in this paper, has been converted into 2008 dollars for ease of comparison. When authors report a range of estimates, we have taken the average and then converted that average into 2008 dollars. Henning Bohn and Robert Inman, “Balanced Budget Rules and Public Deficits: Evidence from the U.S. States” (working paper No. 5533, National Bureau of Economic Research, 1996).


18 Crain, Volatile States: Institutions, Policy and the Performance of American State Economies.

19 Besley and Case, “Political Institutions and Policy Choices: Evidence from the United States.”

20 Waisanen.


22 This is not always true, however. One recent study found TELs to be “largely ineffective.” Thad Kousser, Matthew McCubbins, and Ellen Moule, “For whom the TEL Tolls: Can State Tax and Expenditure Limits Effectively Reduce Spending?” State Politics and Policy Quarterly, Vol. 8 (2008): 331-61.


24 Mitchell, “TEL It Like It Is: Do State Tax and Expenditure Limits Actually Limit Spending?”


28 Abrams and Dougan.


30 Besley and Case, “Political Institutions and Policy Choices: Evidence from the United States.”

31 Vock.

32 Crain, Volatile States: Institutions, Policy and the Performance of American State Economies, 111.
An issue placed on the ballot by petition is an initiative. When the legislature places it on the ballot, it is a referendum. For an overview, see John Matsusaka, For the Many or the Few: The Initiative, Public Policy, and American Democracy, (Chicago: University of Chicago Press, 2008).

For this and other data on direct democracy, see The Initiative and Referendum Institute, The University of Southern California, http://www.iandrinstitute.org/.


In one specification, it did seem to be associated with lower levels of income taxation per capita. Besley and Case, Political Institutions and Policy Choices: Evidence from the United States.


Ibid.

Besley and Case, "Political Institutions and Policy Choices: Evidence from the United States."

Ibid., 55.


According to the CBO’s alternative fiscal scenario (which assumes no change in policy), federal debt held by the public will exceed 90 percent of GDP within a decade. See Congressional Budget Office, op. cit. And according to Miron, 17 states will have accumulated net debt levels in excess of 90 percent of GDP by 2030. See Miron, op. cit.


### Bibliography


*New State Ice Co. v. Liebmann*. 285 U.S. 262 (Supreme Court, 1932).


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