UNITED STATES DISTRICT COURT
DISTRICT OF MAINE

NANCY and LYLE STRICKLAND, Plaintiffs vs. COMMISSIONER, MAINE DEPARTMENT OF HUMAN SERVICES, Defendant vs. MIKE ESPY, SECRETARY UNITED STATES DEPARTMENT OF AGRICULTURE, Third Party Defendant	Civil Action No. 93-189-P-H

AFFIDAVIT OF PETER S. FISHER

I, Peter S. Fisher, being first duly sworn, hereby depose and say:

1. My name is Peter S. Fisher. My address is 3722 Hummingbird Lane SE, Iowa City, Iowa 52240. I am a partner in Fisher, Sheehan, and Colton, a firm of economists specializing in the analysis of public policy. I am also an Associate Professor of Urban and Regional Planning at the University of Iowa.

2. I received a Ph.D. in economics in 1978 from the University of Wisconsin at Madison. Since 1978 I have conducted a wide variety of studies in the area of applied public finance and the analysis of public programs, legislation, and regulation. I have published a substantial number of articles in academic journals. Further information concerning my qualifications is set forth in the curriculum vitae appended hereto.

3. I provide this affidavit in support of the Plaintiffs Nancy and Lyle Strickland and the class of food stamp recipients they represent in this case.

4. I have been asked by the Plaintiffs to give my opinion, as an economist, concerning the refusal by the Secretary of the United States Department of Agriculture (the “Secretary”) to permit depreciation of capital assets as a cost of doing business by self-employed persons for purposes of eligibility and benefits under the Food Stamp Program.

5. Section 2014(d) of the Food Stamp Act, 7 U.S.C.§2011, et. seq. provides that “[h]ousehold income for purposes of the food stamp program shall include all income from whatever source excluding only” certain categories. One such category specifically excluded in Section 2014(d)(9) is “the cost of producing self-employment income….” [Emphasis added.]

6. The current regulations of the Secretary purporting to implement the Food Stamp Program provide that the allowable costs of producing self-employment income include, but are not limited to:

- labor
- stock
- raw material
- seed and fertilizer
- interest paid to purchase income-producing property
- insurance premiums, and
- taxes paid on income-producing property.

However, the same regulations specifically exclude depreciation as an allowable cost of producing self-employment income. 7 C.F.R. §273.11(4)(ii)(D) (the “Regulations”).

7. Contrary to the Secretary’s Regulations at issue, the cost of producing self-employment income necessarily must reflect depreciation of equipment.

8. In the production of income, any business incurs costs, including costs of capital assets. This principle is

self-evident, and can be found in virtually any economics text published since the beginning of that discipline. For example: “Producing units buy factors of production and supply goods and services. Producing units come in all shapes and sizes. They range from the one-man farm or grocery store to the giant corporation…. All use labor, capital… raw materials and other inputs. Use of these inputs involves *costs of production*. The inputs are used to produce outputs which are sold on the market for a price. Over the long run, this price must cover the necessary costs, or production will not continue.” Lloyd G. Reynolds, *Economics: A General Introduction* (1973) at 334. [Emphasis in original.]

9. Imput costs are represented on the firm’s income statement as the “cost of goods sold.” It has long been recognized as an economic principle that the cost of goods sold is the cost of the inputs actually used in the current period of production of those goods, not the outlay for inputs during that period. “Cost in an absolute sense records all diminution of assets …. For example, let us suppose that we want to know the absolute cost of operating a given business, including all money paid out for wages and materials and all actual depreciation or deterioration in the plant itself …. The business firm does not calculate the cost of a given month’s business on the basis of the amount spent in that month for materials, but rather on the basis of the amount of materials issued from the stockrooms for actual use during the period…. It is not until the materials are issued for use that they can be charged against a definite product …. The raising of fixed capital involves a similar principle.” J.M. Clark, *Studies in the Economics of Overhead Costs* (1923) at 38-42. Just as raw materials inputs are charged against production as they are withdrawn from inventory (i.e., as the stock of working capital, or liquid assets, is depleted), so are capital inputs such as equipment charged against production as they are used up (depleting the stock of fixed assets). In the case of capital goods, the charge is called depreciation.

10. Depreciation represents “the lessening in value of a capital asset through wear, deterioration, or obsolescence.” G.T. Stevens, Jr., *Economic and Financial Analysis of Capital Investments* (1979) at 27. As such, “it

is a cost and *must* be taken into account in economic analysis.” *Id*. [Emphasis added.]

11. Accordingly, depreciation represents the dollar value of the asset which is actually consumed in the process of producing income. It is as real and actual an expense as the cost of labor, materials, or utilities used in the course of producing income. Without the use of equipment, and through its use, without the consumption of such equipment, income could not be produced.

12. The foregoing point appears almost too obvious to debate. In fact the very wording of the explanation for the amended Regulations, referring to the “cost of capital goods,” at least acknowledges by clear implication that the cost of equipment is a “cost” of doing business. See para. 17, *infra*.

13. The only feature of the cost of capital goods that distinguishes this cost from other expenses allowed by the Regulations is that it is a *capital* expense. Capital expenses are actual, real and out-of-pocket expenses. The expense is incurred when the equipment is purchased. Sometimes the equipment is purchased from the equity of the business (or the household, in the case of the self-employed), sometimes from the proceeds of a bank loan, and other times by way of installment debt to the seller of the equipment. Whatever the form of the payment, the expense is different from the other expenses allowed by the Regulations in only one respect, i.e., a capital expense is incurred for an asset in advance of its use over time. This fact gives rise to accounting rules which require that the acquisition cost, less the estimated salvage value, to be spread out over the time of purchase. This distinction, however, provides absolutely no basis whatsoever for refusing to recognize depreciation as a cost of doing business.

14. In fact, the only rational alternative to allowing depreciation of the expense of acquiring an asset over the useful life of the equipment would be to permit the cost of the equipment to be recognized in full at the time the expense is incurred.

15. If the Secretary took the position that the expense of a capital asset purchased on credit should be recognized as the loan is repaid, I would still object on the ground that such a scheme is arbitrary and unfair. I would object because equipment purchased with borrowed funds results in an out-of-pocket cost which is just as real as the cost of equipment purchased from equity or from funds given to the self-employed person or from any other source. In each case—regardless of the *source* of the funds—the cost is incurred when money passes from the self-employed person to the seller of the equipment, resulting in the acquisition of the equipment. The proper way to recognize that acquisition expense, as explained, is over the useful life of the asset as that asset contributes to the production of income. It makes no sense for the timing of the expense to depend on the fortuity of the repayment terms of a loan taken out to buy the equipment because the cost of the equipment has already been incurred at the outset, before the loan is repaid. Notwithstanding all these objections, however, at least such a scheme would recognize the cost of the capital asset at some point. Yet the Regulations even prohibit this scheme. They specifically prohibit a deduction for “[p]ayment on the principal of the purchase price of income-producing real estate and capital assets, equipment, machinery, and other durable goods.”

16. Accordingly, in my view, the Secretary’s decision to deny any recognition of the cost of depreciable assets makes no sense at all.

17. In promulgating amendments to the Regulations at issue, the Secretary gave the following explanation for his position:

> “Allowing such costs when determining net self-employment income results in an exemption of [a]mounts not constituting ‘actual costs’ to the household; households are, in a sense, given a deduction in advance for the cost of capital goods, which is otherwise not allowed.”

46 F. Reg. 4646 (Jan. 16, 1981). This explanation contains three rationales for the denial of depreciation deductions. I will discuss them in turn.

18. The first is that depreciation results in an exemption or allowable expense for amounts not constituting “actual costs.” One interpretation of this rationale is that “actual costs” means cash or out-of-pocket expense and the Secretary’s Regulations intend to only allow a deduction for cash capital expenses. But, of course, the Regulations do not allow for the cost of equipment purchased with cash. Nor do they allow for the cost of depreciable equipment paid for over time in a credit transaction. They simply disallow the cost, period.

19. Alternatively, the Secretary may have meant that capital costs in general are not “actual costs.” But this would plainly be absurd. The cost of a capital asset is an actual cost in every sense of the phrase, as emphasized above. The only issue is the period of time over which the cost should be recognized.

20. The second rationale of the Secretary is that to allow depreciation would be to allow a deduction in advance of the actual expense. It is very difficult to understand how the Secretary reached this conclusion because the precise reverse is true. Depreciation deductions are always, and by definition, deductions taken *after* capital goods are acquired, to reflect the portion of their value that is consumed during the current period. One cannot take a deduction of an asset that one does not yet own. Depreciation is never taken “in advance,” but quite the opposite. Depreciation is a way of deducting a capital cost gradually over the useful life of the asset, and is an alternative to expensing entirely in the year of acquisition.

21. The only explanation for the Secretary’s rationale that depreciation represents a deduction “in advance” is a confusion between depreciation deductions and deposits into an equipment replacement reserve fund. If this is so, it represents a startling ignorance of the purpose for recognizing the cost of depreciation in the production of income. Depreciation is a way of recognizing the value of the consumption of an asset already acquired. As explained above, it is measured by the original cost of the equipment (not its replacement value) reduced by the salvage value and it is taken over the useful life of the asset. It has nothing to do with saving up for the purchase of a new

asset sometime in the future. Though a self-employed individual may, indeed, put cash aside to pay for the eventual replacement of assets, such savings to cover estimated future replacement costs do not necessarily bear any relationship to the actual costs of existing assets; nor do economists or accountants ever argue that such savings deposits can or should be recognized as an expense.

22. The third rationale contained in the Secretary’s explanation seems to be that depreciation deductions are some kind of a subterfuge, because they result in a deduction of a cost which is “otherwise not allowed.” The obvious question raised is: not allowed by whom? Accountants require recognition of depreciation. The Internal Revenue Code requires it. There is nothing in the Food Stamp Act that requires or even implies that deductions for the purchase of capital assets are disallowed. It is only the Secretary’s own arbitrary Regulations that “otherwise do not allow” the deduction of the principal payments on loans to acquire capital assets. The Regulations appropriately do not provide for the repayment schedule on a loan as the measure of the cost of a wasting asset, as explained above. But that does not justify a failure to recognize the universally recognized proper method of recognizing the cost of depreciable equipment. In summary, this part of the Secretary’s reasoning is at best circuitous.

23. The Secretary’s Regulations are not only arbitrary and unjustified, but they are unfair and discriminatory as well. A simple example explains why. A self-employed individual may conduct business either with equipment that is owned or equipment that is rented. If the equipment is owned, no allowance is permitted under the Regulations for the cost of the equipment, at the time of purchase or as it is consumed through use. In contrast, if the same equipment is leased by the self-employed individual, the Regulations permit full deductions for rent. In making equipment rental payments, the self-employed individual is indirectly making payments for equipment depreciation. This is a matter of elementary economics, for the amount of rent charged by the owner of the equipment must be sufficient to cover the cost of the equipment as it depreciates. The equipment lessor, after all, is in business to make a profit, i.e., to earn a return over and above the costs of acquiring and

maintaining the equipment. As with any business, asset acquisition costs consist of depreciation, as explained above. Accordingly the Regulations reflect a blatant prejudice against the ownership of depreciable assets for purposes of the Food Stamp Program.

24. Not only is such discrimination without any economic justification, or any other justification that I can imagine, but it appears to contradict the intent of Congress when it enacted the program. In House Report No. 95-464, reproduced in 1977 U.S. Code Cong. and Admin. News 1978 at page 2067 the authors of the Food Stamp Program explained:

> The tools of a tradesman would, of course, remain excluded as income-producing property, thereby providing access to the food stamp program to the small businessman who has fallen on hard times or has become temporarily disabled with little or no income and who would not have to sell all of his equipment in order to become eligible and, thus, be forced to become almost a permanent ward of the state simply in order to eat.

Congress clearly intended that the ownership of income-producing equipment by a self-employed individual would not disqualify that person from eligibility under the Food Stamp Program. It does not make sense, then, to promulgate Regulations that discriminate against the same person by reason of his or her ownership of such assets.

25. By excluding income-producing assets from the asset test, Congress avoided creating an incentive for potential Food Stamp recipients to sell business equipment in order to become eligible for benefits. Yet the Regulation disallowing the deduction for depreciation on such equipment causes just that incentive. The exclusion of depreciation from income could force an individual, otherwise eligible for benefits, to sell the very assets that in the long run could provide the basis for self-sufficiency. Such an individual may be “forced to become almost a permanent ward of the state,” dependent on the Food Stamp Program and other programs, such as AFDC. This runs directly counter to the purpose of the Food Stamp Program, as well as the purposes of AFDC and SSI.

26. In summary, I have concluded that the portion of the Regulations that refuses to allow an offset for depreciation for purposes of eligibility and benefits under the Food Stamp Program for self-employed individuals is arbitrary, irrational, discriminatory and without any justifiable basis. The decision to exclude depreciation as an allowable expense can only be the product of a misunderstanding of the concept of depreciation and its function in business operations.

DATED: ____________________________

Peter S. Fisher

STATE OF IOWA
JOHNSON, SS

December 20, 1993

Personally appeared before me the above-mentioned Peter S. Fisher and made oath that the statements contained in his Affidavit are based on his own personal knowledge and are true.

Before me,

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