A MESSAGE FROM THE SECRETARY OF THE TREASURY

I am pleased to present the fiscal year 2001 *Financial Report of the United States Government.* The Report includes audited financial statements that cover the executive branch, as well as parts of the legislative and judicial branches of the U.S. Government. In five years, we have made considerable progress but still have much to accomplish in order to reach our goal of timely and useful financial reporting.

Accrual based financial reporting is critical to gaining a comprehensive understanding of the U.S. Government's operations. For fiscal year 2001, our results were an accrual-based deficit of $515 billion in contrast to a $127 billion budget surplus reported last fall. The primary difference between the accrual deficit and the budget surplus is the recognition of expanded military retiree health benefit costs provided by the National Defense Authorization Act, which was signed into law on October 30, 2000, and other actuarial expenses. In fact, these expenses caused the government's future obligations to its military and civilian retirees to exceed the federal debt held by the public. As with other future obligations of the federal government, only accrual-based financial reporting provides this information in context to the public.

The drive to produce financial reports that better disclose our activities to the Congress and the public continues. This year, for the first time, we are presenting two years of data to facilitate comparative analysis. In addition, we have added two new financial statements. The Reconciliation of Net Operating Revenue/(Cost) to the Budget Surplus (unaudited) explains the differences between the accrual and budget results. The Disposition of the Budget Surplus (unaudited) explains how the budgetary surplus was utilized.

We have made progress toward the three goals I laid out last year.

- For fiscal year 2004, agencies' financial statements are due 45 days after the fiscal year-end with the consolidated Financial Report due by December 15th. This accelerated timing will finally allow adequate time to have the financial statements considered in the budget process. The ultimate goal of the financial information in this report is for it to be used by decision-makers to improve the management and programs of the Federal government.
- After completing our review, we are implementing a new process, developed in consultation with the Office of Management and Budget and the General Accounting Office, for preparing future financial statements which will enhance their integrity.
- The Treasury Department continues to develop a governmentwide accounting system that will greatly improve the agencies' access to data, reduce redundant data reporting, and eliminate reconciliations between the cash amounts shown on agency and Treasury books.

I believe that the American people deserve the highest standards of accountability and professionalism from their Government and I will not rest until we achieve them.

Paul H. O'Neill

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MANAGEMENT'S DISCUSSION AND ANALYSIS

Introduction

We are pleased to present the consolidated *Financial Report of the United States Government (Financial Report)*. This year, for the first time, we are presenting two years of financial information to facilitate comparative analysis, and have added two new financial statements to help explain the differences between the accrual-based deficit and the budget surplus, and to explain how the budgetary surplus was used. Although we continue to receive a disclaimer of opinion from our auditors, in this our 5th year of preparing financial statements, we are making progress in our quest to report the financial activities of the U.S. Government timely, reliably, and in a format useful to the readers. For the second consecutive year, all 24 of the largest departments and agencies completed their financial statements on time and 18 received an unqualified or clean opinion. We are committed and will continue to work to improve financial management, modernize the Government's financial management systems, and strengthen financial reporting. Our objective is to provide useful, timely reports of financial information to the American public and the world. To that end, we have set the objective of issuing this report for fiscal 2004 operations by December 15, 2004.

The accompanying *Financial Report* is required by 31 U.S.C. § 331(e)(1) to be submitted to Congress by March 31, and consists of Management's Discussion and Analysis (MD&A), Statements of Net Cost, Statements of Operations and Changes in Net Position, Reconciliations of Net Operating Revenue/(Cost) to the Budget Surplus (Unaudited), Dispositions of the Budget Surplus (Unaudited), Balance Sheets, Stewardship Information, Notes to the Financial Statements, and Supplemental Information. Each section is preceded by a description of its contents.

Executive Summary

With the arrival of the new Administration last year, a major new initiative, "The President's Management Agenda," was launched. The President's Management Agenda is a strategy for improving the management and performance of the Federal Government. Government likes to begin programs, but beginnings are not the measure of success. What matters in the end is achievement of results. The President's Management Agenda focuses on 14 areas of improvement where the Federal Government can begin to deliver on its promises. The 14 targeted areas address the most apparent deficiencies where the opportunity to improve performance is the greatest.

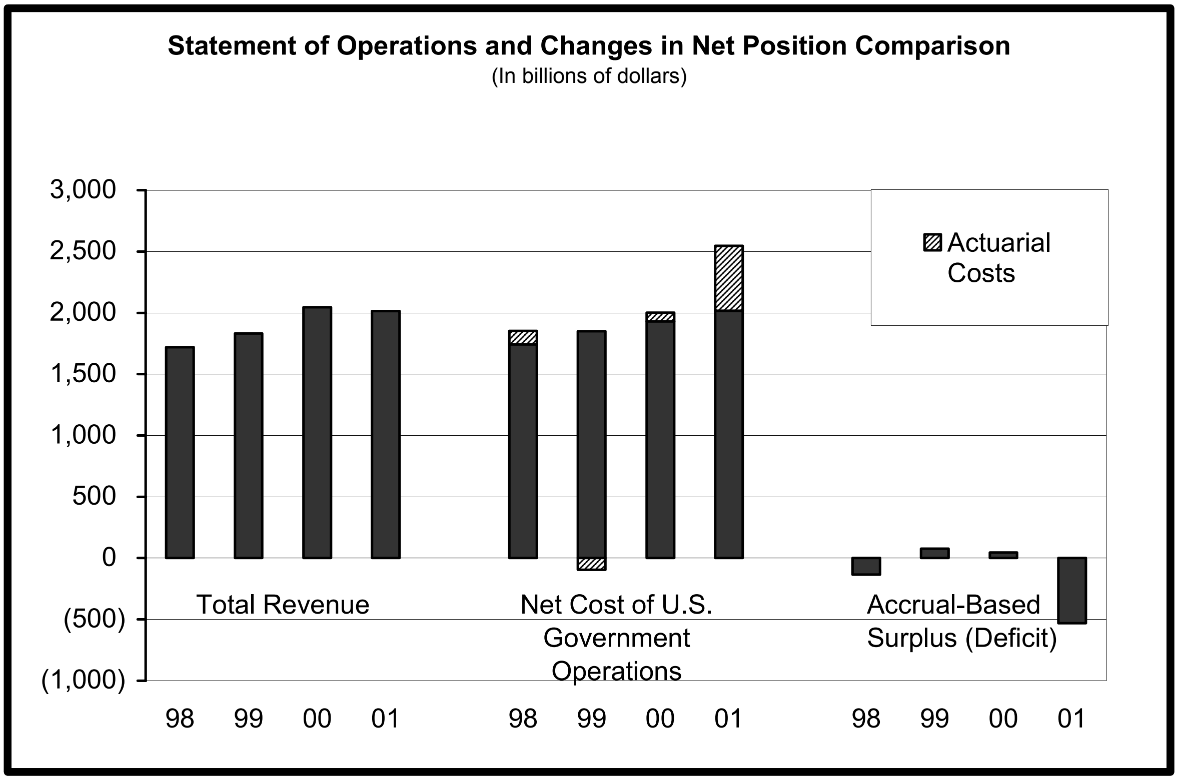
Five of the 14 targeted areas are Governmentwide initiatives, including:

- Strategic Management of Human Capital.
- Competitive Sourcing.
- Improved Financial Performance.
- Expanded Electronic Government.
- Budget and Performance Integration.

The remaining nine initiatives are program specific, including:

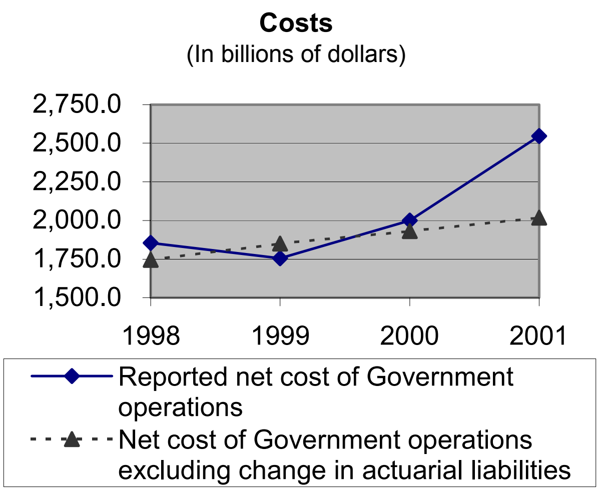
- Faith-Based and Community Initiative.
- Privatization of Military Housing.
- Better Research and Development Investment Criteria.
- Elimination of Fraud and Error in Student Aid Programs and Deficiencies in Financial Management.
- Housing and Urban Development Management and Performance.
- Broadened Health Insurance Coverage through State Initiatives.
- A "Right-Sized" Overseas Presence.
- Reform of Food Aid Programs.
- Coordination of Veterans Affairs and Defense Programs and Systems.

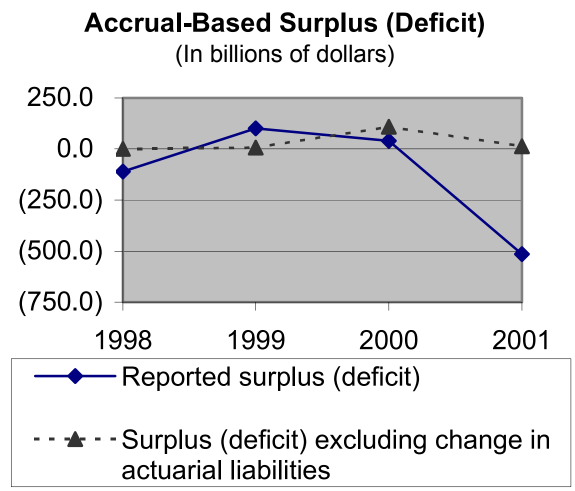
The President's Management Agenda is a starting point for management reform. It reflects the Administration's commitment to achieve concrete and measurable results in the near term. It focuses on remedies to problems generally agreed to be serious and commits to implement them fully. The goals of this agenda are being undertaken in advance of, not instead of, other needed management improvements. Additional goals will be undertaken as tangible improvements are made in this initial set of initiatives.



The above chart shows that the financial results moved to a deficit in fiscal 2001. In this report, the term surplus/deficit refers to accrual-based amounts, and references to budget-based surplus/deficit amounts will always be preceded by the term budget. The deficit was $514.8 billion in fiscal 2001, as compared to a surplus of $39.6 billion for fiscal 2000. Despite the deficit, the Government paid down an additional $90.1 billion in debt held by the public. As a result of sustained debt reductions and a significant increase in Federal employee and veteran benefits payable, this year debt held by the public is no longer the largest liability on the Government's balance sheets. As is also evident in the chart, revenues failed to increase in fiscal 2001; in fact they decreased modestly by $31.1 billion from fiscal 2000 due to lower corporate income tax receipts reflecting the impact of a weakening economy and the one-time shift of $23 billion of the September estimated corporate tax payments into October. The Net Cost of U.S. Government Operations increased significantly in fiscal 2001 by $545.4 billion when compared to fiscal 2000 costs. The largest reason for the increase is due to the effect of a new law that increased the military retirement health benefits liability by $293.0 billion. Under this legislation, TRICARE benefits are extended to military retirees and their beneficiaries who are eligible for Medicare, and a fund is established to pay these benefits (a new intragovernmental investment fund similar to those for other Federal pension programs). This resulted in civilian and military retirement and post-retirement health care becoming the largest liability of the Federal Government.

Over the past 4 fiscal years, significant adjustments to the actuarial liabilities have had large effects on the Governmentwide net cost of operations and the surplus (deficit). The following charts show that absent these adjustments, costs are trending upward at a 3 to 4 percent rate and the net cost has varied within a range from break-even to a $115 billion surplus. Actuarial liabilities include Federal employee and veteran benefits payable and are discussed in Note 11 of the Notes to the Financial Statements. In fiscal 1998 through 2001, there have been significant changes in the veterans compensation and burial benefits liability in the following amounts: increase of $109.8 billion in fiscal 1998, decrease of $94.9 billion in fiscal 1999, increase of $69.4 billion in fiscal 2000, and increase of $139.3 billion in fiscal 2001. These significant changes are a result of changes in interest rate and other actuarial assumptions. In addition to the $293.0 billion increase in the military retirement health benefits liability (as mentioned in the previous paragraph), there has also been a $91.3 billion increase in other actuarial assumption changes relating to the military retirement health benefits.





Mission and Organizational Structure

No other entity in the world compares in size, scope, and complexity to the U.S. Government. Its budgeted outlays were $1.9 trillion in 2001. A civilian Federal workforce of 2.7 million individuals plus 1.4 million Department of Defense active duty military personnel serves a diverse Nation of more than 278 million Americans.

To fulfill its constitutional mandates, the U.S. Government undertakes a wide variety of programs to:

- Maintain strong, ready, and modern military forces.
- Provide homeland security.
- Provide critical international leadership.
- Contribute to energy security.
- Protect the environment.
- Boost agricultural productivity.
- Facilitate commerce and support housing.
- Support the transportation system.
- Help economically distressed urban and rural communities.
- Assist States and localities in providing essential education and training.
- Promote health care.
- Foster income security.
- Provide benefits and services to veterans.
- Administer justice.

The form of Government that exists in the United States is a constitutional representative democracy. The following organization chart illustrates the constitutionally mandated separation of powers into the three main branches of Government. It also illustrates the breadth and complexity of the executive branch.

THE GOVERNMENT OF THE UNITED STATES

THE CONSTITUTION

LEGISLATIVE BRANCH

THE CONGRESS

SENATE HOUSE

Architect of the Capital
United States Botanic Garden
General Accounting Office
Government Printing Office
Library of Congress
Congressional Budget Office

EXECUTIVE BRANCH

THE PRESIDENT
THE VICE PRESIDENT
Executive Office of the President

White House Office
Office of the Vice President
Council of Economic Advisers
Council on Environmental Quality
National Security Council
Office of Administration
Office of Homeland Security (*)
Office of Management and Budget
Office of National Drug Control Policy
Office of Policy Development
Office of Science and Technology Policy
Office of the U.S. Trade Representative
(*) Per Executive Order # 13228, signed 10/08/01

JUDICIAL BRANCH

THE SUPREME COURT OF THE UNITED STATES

United States Courts of Appeals
United States District Courts
Territorial Courts
United States Court of International Trade
United States Court of Federal Claims
United States Court of Appeals for the Armed Forces
United States Tax Court
United States Court of Appeals for Veterans Claims
Administrative Office of the United States Courts
Federal Judicial Center
United States Sentencing Commission

DEPARTMENT OF AGRICULTURE
DEPARTMENT OF COMMERCE
DEPARTMENT OF DEFENSE
DEPARTMENT OF EDUCATION
DEPARTMENT OF ENERGY
DEPARTMENT OF HEALTH AND HUMAN SERVICES
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

DEPARTMENT OF THE INTERIOR
DEPARTMENT OF JUSTICE
DEPARTMENT OF LABOR
DEPARTMENT OF STATE
DEPARTMENT OF TRANSPORTATION
DEPARTMENT OF THE TREASURY
DEPARTMENT OF VETERANS AFFAIRS

INDEPENDENT ESTABLISHMENTS AND GOVERNMENT CORPORATIONS

African Development Foundation
Central Intelligence Agency
Commodity Futures Trading Commission
Consumer Product Safety Commission
Corporation for National and Community Service
Defense Nuclear Facilities Safety Board
Environmental Protection Agency
Equal Employment Opportunity Commission
Export-Import Bank of the U.S.
Farm Credit Administration
Federal Communications Commission
Federal Deposit Insurance Corporation
Federal Election Commission
Federal Emergency Management Agency
Federal Housing Finance Board
Federal Labor Relations Authority
Federal Maritime Commission
Federal Mediation and Conciliation Service
Federal Mine Safety and Health Review Commission
Federal Reserve System
Federal Retirement Thrift Investment Board
Federal Trade Commission
General Services Administration
Inter-American Foundation
Merit Systems Protection Board
National Aeronautics and Space Administration
National Archives and Records Administration
National Capital Planning Commission
National Credit Union Administration
National Foundation on the Arts and the Humanities
National Labor Relations Board
National Mediation Board
National Railroad Passenger Corporation (Amtrak)
National Science Foundation
National Transportation Safety Board
Nuclear Regulatory Commission
Occupational Safety and Health Review Commission
Office of Government Ethics
Office of Personnel Management
Office of Special Counsel
Overseas Private Investment Corporation
Peace Corps
Pension Benefit Guaranty Corporation
Postal Rate Commission
Railroad Retirement Board
Securities and Exchange Commission
Selective Service System
Small Business Administration
Social Security Administration
Tennessee Valley Authority
Trade and Development Agency
U.S. Agency for International Development
U.S. Commission on Civil Rights
U.S. International Trade Commission
U.S. Postal Service

Source: *U.S. Government Manual 2001-2002*

The United States is impressive in its position as one of the world powers. The following table illustrates several interesting facts about the United States, as compared with other countries.

Item of Interest	Amount for the United States	Information as of	Country Rank	Comments
Land area	9,158,960 square kilometers		4th	Russia, China, and Canada are larger
Population	278.1 million	July 2001 est.	3rd	China and India are greater
Gross domestic product	$9.963 trillion	2000 est.	1st	China was second with $4.5 trillion
Gross domestic product–per capita	$36,200	2000 est.	2nd	Luxembourg was first with $36,400
Electricity–production	3.678 trillion kilowatt-hour	1999	1st	China was second with 1.173 trillion
Military expenditures–percent of gross domestic product	3.20 percent	Fiscal 1999 est.	41st	North Korea was first with an estimate of 25-33 percent
SOURCE: Central Intelligence Agency's *The World Factbook 2001*				

Financial Results

The deficit as shown in these financial statements for fiscal 2001 is $514.8 billion, as compared to a budget surplus of $127.0 billion. The primary components of the difference between the budget and accrual numbers are increases in the liability for military health liabilities of $388.6 billion, and an increase in the liability for veterans disability of $115.2 billion. For a detailed reconciliation showing the differences, see the Reconciliations of Net Operating Revenue/(Cost) to the Budget Surplus (Unaudited) statement in the Financial Statements section.

In fiscal 2000, the financial statements showed a surplus of $39.6 billion, as compared to a budget surplus of $236.9 billion.

Revenue and Cost Summary

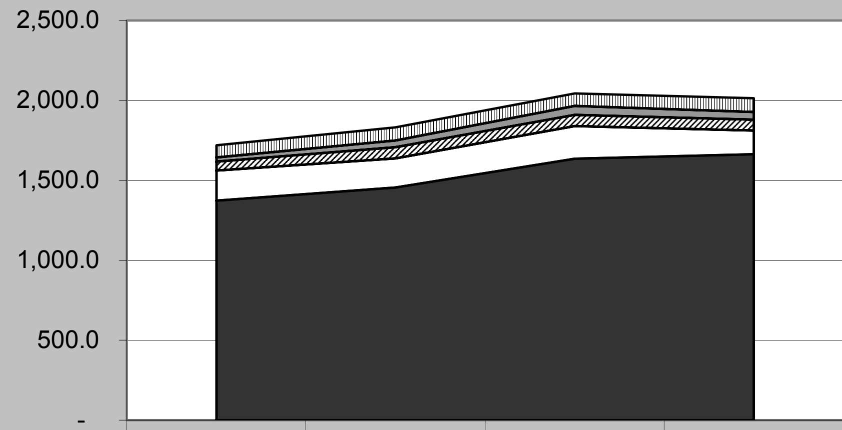
Revenue

Government revenue comes from two sources: nonexchange transactions and exchange transactions. Nonexchange revenues arise primarily from exercise of the Government's power to demand payments from the public (e.g., taxes, duties, fines, and penalties). Nonexchange revenue is the U.S. Government's primary source of revenue and totaled $2,001.4 billion in fiscal 2001, as compared to $2,040.0 billion in fiscal 2000. More than 98 percent of this total came from tax receipts, with the remainder coming from customs duties and other miscellaneous receipts. The reduction in nonexchange revenue was due to lower corporate income tax receipts reflecting the impact of a weakening economy and the one-time shift of September estimated corporate tax payments into October. The shift amounted to roughly $23 billion moving into October. The Government also issued $35.2 billion in tax rebate checks to individual taxpayers during the fiscal year.

Exchange revenues arise when a Government entity provides goods and services to the public for a price. Another term for exchange revenue is earned revenue. Examples of exchange revenues are the mailing and postage revenue for the U.S. Postal Service and Medicare Part B premiums collected by the Department of Health and Human Services. During fiscal 2001, the U.S. Government earned $172.3 billion in exchange revenue, as compared with $161.7 billion in fiscal 2000. Of these revenues, $160.0 billion is offset against the gross cost of the related agencies' programs to arrive at the agencies' net cost, as compared with $156.9 billion for fiscal 2000. Also included is $12.3 billion ($4.8 billion in fiscal 2000) that was earned by the U.S. Government but not offset against the cost of any program (e.g., royalties on the Outer Continental Shelf Lands).

The following chart shows the components of revenue by major source.

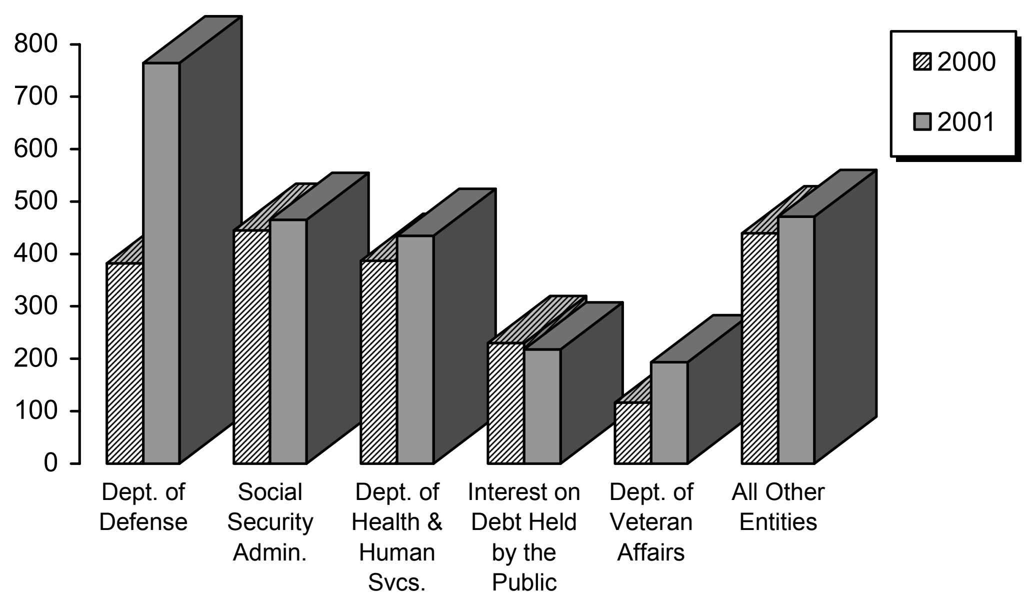
Components of Revenue by Major Source
(In billions of dollars)



	1998	1999	2000	2001
All others	75.5	82.2	79.7	86.0
Other taxes and receipts	26.6	42.0	56.3	48.9
Excise taxes	57.6	70.5	69.3	67.3
Corporation income taxes	186.3	182.2	204.3	147.9
Individual income tax and tax withholdings	1,374.2	1,456.0	1,635.2	1,663.6

Cost

Net Cost Comparison
(In billions of dollars)



The above chart compares significant elements of net cost by fiscal year. As noted earlier, the significant increase in Department of Defense cost reflected the effect of the extension of medical benefits to retired personnel in the amount of $293.0 billion, plus another $91.3 billion in other actuarial assumption changes. The second largest change was the increase in the Department of Veterans Affairs in the amount of $76.9 billion for actuarial assumption changes for veterans compensation and burial benefits. The net costs of the Department of Health and Human Services increased by $47.3 billion due primarily to a $22 billion increase in Medicare and a $12 billion increase in Medicaid.

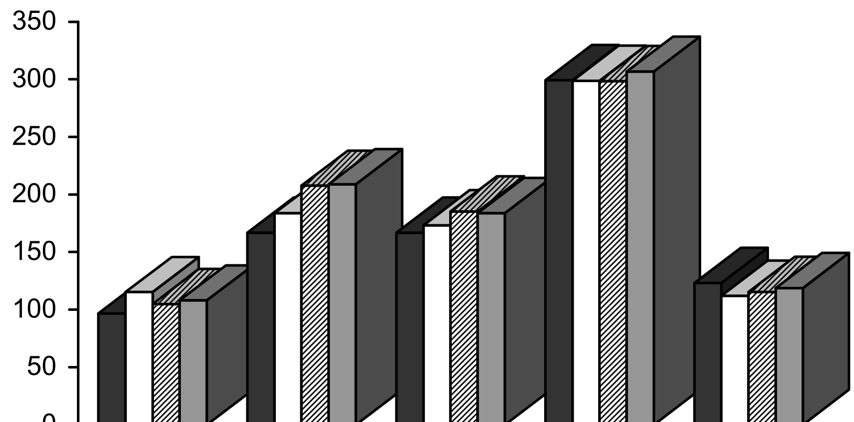
The net cost of U.S. Government operations was $2,545.8 billion for fiscal 2001, as compared to $2,000.4 billion for fiscal 2000. Net cost represents the gross cost of operations less related earned revenues. The Statement of Net Cost reflects the cost incurred to carry out the national priorities identified by the President and the Congress, and are shown by major agency or entity.

Asset and Liability Summary

Assets

The assets of the U.S. Government are the tangible resources available to pay liabilities or to satisfy future service needs. The accompanying chart depicts a four-year comparison of the major categories of reported assets as of September 30, for fiscal years 1998 through 2001.

Assets - Key Items Comparison
(In billions of dollars)



	Cash and Other Monetary Assets	Loans Receivable	Inventories and Related Property	Property, Plant and Equipment	All Other Assets
1998	96.8	166.8	166.8	299.3	123.1
1999	115.2	183.7	173.3	298.8	112.0
2000	104.9	207.6	185.2	298.5	115.3
2001	108.0	208.9	183.8	306.7	118.7

As can be seen from the above chart, in fiscal 2001, assets remained relatively constant from fiscal 2000. However, the assets presented on the Balance Sheets are not a comprehensive list of Federal resources. Natural resources, stewardship land (national parks, forests, and grazing lands), national defense assets, heritage assets, and the Government's sovereign powers to tax, regulate commerce, and set monetary policy are examples of resources that are not included in the assets reported on the Balance Sheets. Detailed information about national defense assets, stewardship land, and heritage assets can be found in the Stewardship Information section. Another example, the U.S. Government's most important financial resource, its ability to tax and regulate commerce, cannot be quantified and is not reflected.

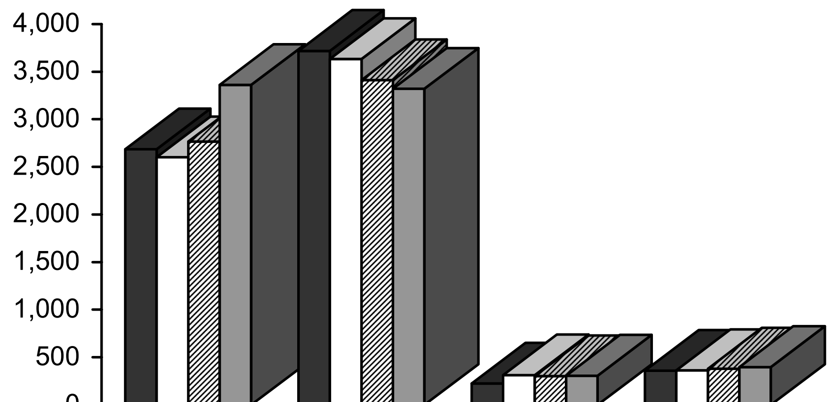
Liabilities

At the end of fiscal 2001, the U.S. Government reported liabilities of $7,384.9 billion, as compared with $6,856.9 billion for September 30, 2000. The largest component of these liabilities ($3,360.8 billion) is represented by pension, disability, and health care costs for Federal civilian and military employees as well as for veterans, as compared to $2,764.7 billion for September 30, 2000. During fiscal 2001, the increase of $406.8 billion for military employee benefits was due mostly to reflecting the effect of the National Defense Authorization Act and other actuarial assumption changes. The increase of $139.3 billion for veterans compensation and burial benefits was the result of changes in interest rate and other actuarial assumptions. See Note 11 in the Notes to the Financial Statements for a more detailed explanation for these changes. During fiscal 2000, changes in actuarial and interest rate assumptions were the primary factors contributing to the increase of $69.4 billion for veterans compensation and burial benefits payable. The next largest liability ($3,319.8 billion) relates to Federal debt securities held by the public, as compared to $3,409.9 billion for September 30, 2000, and reflects a $90.1 billion pay down in the debt held by the public. Another liability is related to environmental cleanup costs associated with environmental damage/contamination. As of September 30, 2001, the recognized cost of cleaning up environmental damage/contamination across Government programs was estimated to be $306.8 billion, as compared to $301.2 billion for September 30, 2000.

The accompanying chart presents a four-year comparison of the major components of liabilities reported on the Balance Sheets as of September 30, for fiscal years 1998 through 2001.

Liabilities - Key Items Comparison

(In billions of dollars)



	Federal Employee and Veteran Benefits Payable	Federal Debt Securities Held by the Public	Environmental and Disposal Liabilities	All Other Liabilities
1998	2,685.1	3,717.7	224.5	359.9
1999	2,600.7	3,631.6	313.2	363.7
2000	2,764.7	3,409.9	301.2	381.1
2001	3,360.8	3,319.8	306.8	397.5

As clearly shown above, the Federal debt securities held by the public have decreased significantly over the past 3 years. The reduction in fiscal 2001 was $90.1 billion, as compared with a $222.7 billion reduction for fiscal 2000. The chart also shows the significant increases in Federal employee and veteran benefits payable for the past two fiscal years, as explained above. Significant future commitments that are not reported as liabilities are the Social Security and Medicare programs. Under existing accounting standards, the future costs of these programs are contained in the Stewardship Section and discussed under Future Commitments. We believe that one of the most important issues facing the newly reconstituted Federal Accounting Standards Advisory Board (FASAB) will be the treatment of social insurance.

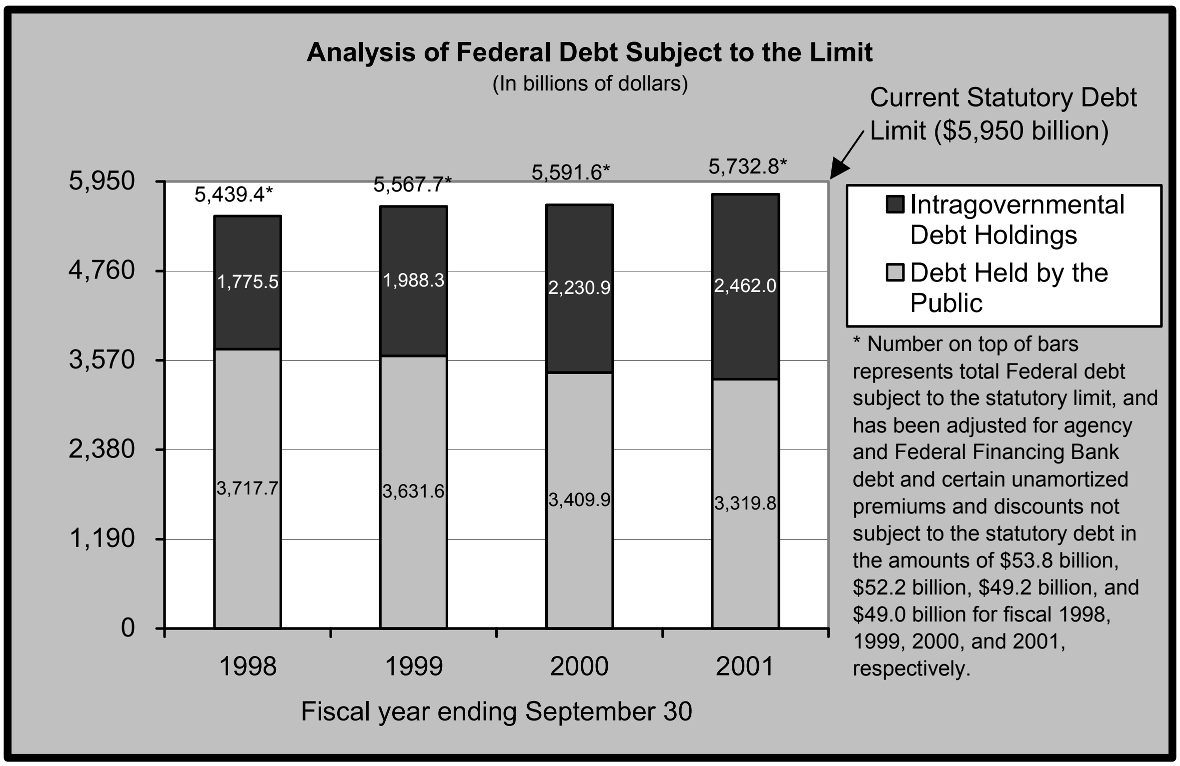
Federal Debt and Budget Surpluses

Although we have had 4 consecutive years of budget surpluses, it is important to understand the composition of budget surpluses, and the relationship that these excess funds have had on reducing or changing the composition of the Federal debt. There are two components of Federal debt: debt held by the public and intragovernmental debt holdings.

Debt held by the public includes all Federal debt held by individuals, corporations, State or local governments, Federal Reserve Banks, foreign Governments, and other entities outside of the U.S. Government. The types of securities held by the public include, but are not limited to, Treasury Bills, Treasury Notes, Treasury Bonds, U.S. Savings Bonds, State and Local Government Series securities, Foreign Series securities, and Domestic Series securities.

Intragovernmental debt holdings generally include nonmarketable securities held by various elements of the Government itself. The laws establishing Government trust funds (such as the Social Security and Medicare Trust Funds) generally require the balances to be invested in these special securities. Although intragovernmental debt holdings are used in the calculation of the Federal debt subject to the statutory debt limit, intragovernmental transactions are eliminated in the consolidation process of preparing this *Financial Report* since they are claims of one part of the Government against another part. However, they are important to an understanding of total debt because, as the intragovernmental securities are redeemed, other sources of funds will be used to fund the redemptions.

The following chart presents a 4-year comparison of the components of Federal debt subject to the statutory debt limit.

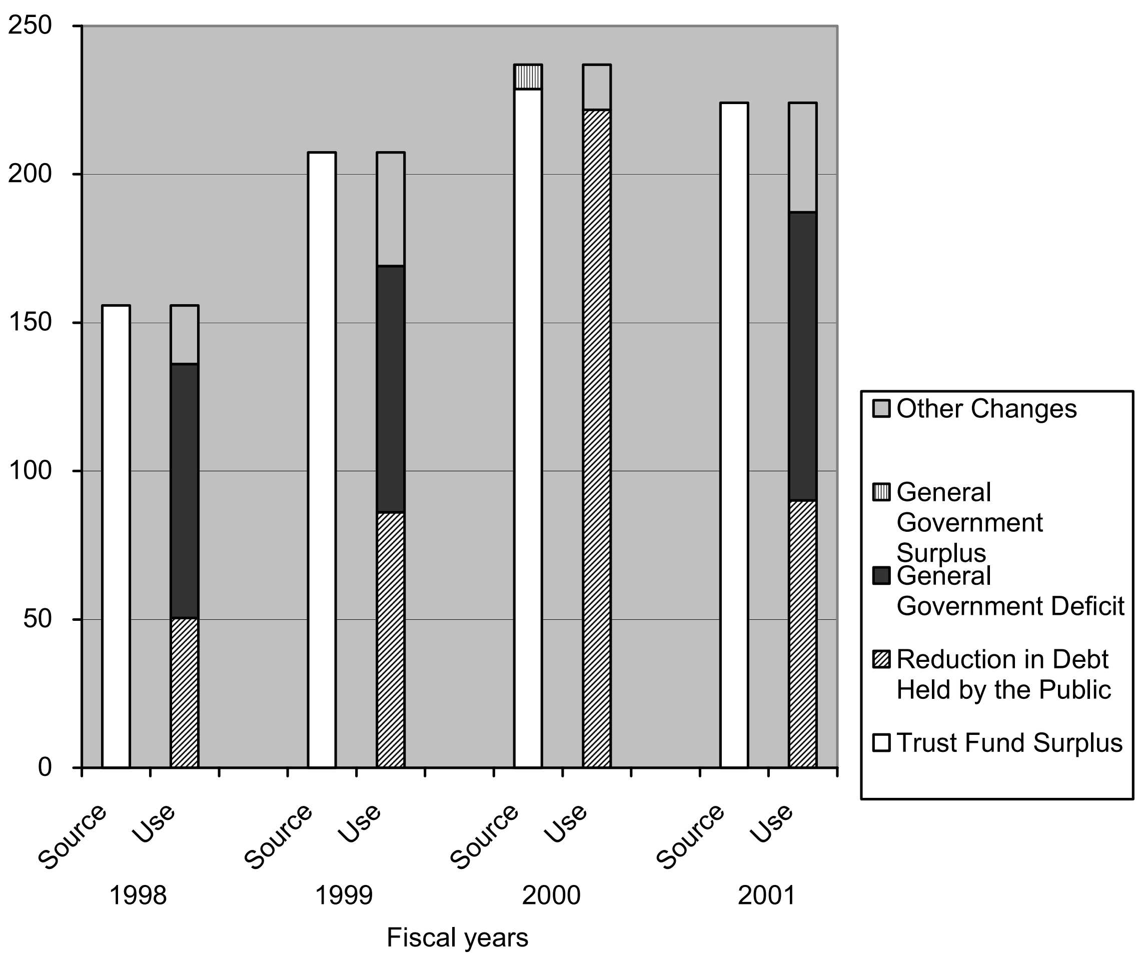


As can be seen from the above chart, debt held by the public has been reduced by almost $400 billion since 1998; however, total debt subject to the limit has risen by $293 billion over the same period. This is because the intragovernmental debt holdings have risen faster than the debt held by the public has been repaid. Treasury has requested that the statutory debt ceiling be raised to $6,700 billion. This was in response to the Administration's projection that the current debt ceiling, $5,950 billion, was expected to be reached by the end of March 2002. As of March 20, 2002, total Federal debt subject to the limit was $5,938 billion ($12 billion from the limit).

Treasury's need to borrow from the public has declined over the past several years. Debt maturing has exceeded the Government's cash surplus; therefore, new securities have continued to be issued. To adjust the Government's borrowing program, Treasury has taken a number of actions, including initiating a buyback program in fiscal 2000, which is a competitive redemption process by which Treasury accepts offers to redeem certain marketable Treasury securities (debt held by the public) prior to their maturity date. During fiscal 2001, a total of 23 buybacks occurred involving the redemption of $33.8 billion par amount of marketable Treasury securities at a total cost of $44.4 billion. This compares to a total of 13 buybacks involving the redemption of $21.3 billion par amount of marketable Treasury securities at a total cost of $26.7 billion for fiscal 2000.

Federal Government operations are composed of two parts: trust funds, which receive their funding from dedicated collections, and general Government, which is funded from general revenues. Many of the larger trust funds finance social insurance programs (such as Social Security and Medicare) and Federal military and civilian retirement programs. Other major trust funds finance highway and transit construction and airport development. The following chart illustrates a 4-year comparison of the budget surpluses or deficits of these two parts of Government and how the budget surpluses were used.

4-Year Comparison of Sources and Uses of the Budget Surplus
(In billions of dollars)



Source: United States Government Annual Report

Trust fund surpluses (the white area in the chart) are invested in Treasury securities. The cash invested in Treasury securities is mainly used for two purposes: to reduce the debt held by the public (the diagonally striped area) and to fund the general Government deficits (the black area). Other changes (the gray area) consist primarily of outlays under various loan programs. Therefore, in most years, only a portion of the budget surplus could be used to reduce the debt held by the public.

The budget surpluses, based primarily on a cash basis, are due almost entirely to the trust fund surpluses. General Government operations experienced budget deficits for fiscal 1998, 1999, and 2001, but had a budget surplus for fiscal 2000.

Future Commitments

September 11: A terrible wrong and a call to action

Americans will never forget the murderous events of September 11, 2001. The threat of mass-destruction terrorism is now a reality of life—a condition to which not just America, but the entire world, must adjust. New challenges of monumental scale and complexity confront our Nation as we wage war against terrorism and take measures to ensure the defense of our homeland. The war against terrorism will be waged on the financial, diplomatic, and intelligence fronts as much as on the battlefield. We must combat terrorism both abroad and at home, protect our people, and preserve our constitutional freedoms. Our military must be strengthened still further so it can act still more effectively to find, pursue, and destroy our enemies. We have priorities at home as well—restoring health to our economy above all.

This new war will be costly. Some of those costs will not show up directly on the Government's books. Terrorism has already inflicted considerable losses on the private economy, and now entrepreneurs and employers will have to shoulder the expense of still-tighter security at points of vulnerability. Government at all levels—Federal, State, and local—will have new bills to pay. Achieving our homeland security objectives will require vast sums of money, strenuous labor, and many years. Clearly, future decisions about how to use our Nation's vast resources will be influenced heavily by the compelling need to protect all Americans and our way of life.

Social Security and Medicare: Fiscal Challenges Looming on the Horizon

For 66 years, Social Security has provided retirement security for tens of millions of Americans. Like Social Security, Medicare also represents a promise the Nation has made to its citizens. As demographics change and costs increase, ensuring these two programs are strengthened for tomorrow's retirees and beneficiaries poses a long-term fiscal challenge. Reform is significantly easier to implement if done far in advance, so individuals and families have time to adjust their personal plans and changes can be phased in slowly over time.

Both Social Security's and Medicare's spending paths are unsustainable in the long run, because they are driven largely by demographic trends. First, longer life spans mean more benefit payments. Advances in health and well-being have led to significant increases in the average life span in the 21st century. The net result is that people spend a growing proportion of their lives in retirement and face the inevitable medical needs brought about by aging. While longer life spans are clearly desirable, they also mean additional years of Social Security and Medicare payments, and a dramatic long-term increase in Government obligations.

Compounding this problem is the long-term decline in the ratio of workers to beneficiaries. This means there will be fewer workers available to support each beneficiary once the baby boom generation starts to retire.

Under current legislation and using intermediate assumptions, the Trustees estimated in their 2002 report that by 2017, cash disbursements for the Social Security programs will exceed cash receipts from taxes, and by 2041, the combined trust fund assets, primarily investments in special Treasury securities, will be exhausted. By 2041, dedicated tax revenues would be sufficient to pay only approximately 73 percent of the benefits due. Additional information about the Social Security program, including updated information from the 2002 Trustees' Report, can be found in the Stewardship Information section of this *Financial Report*.

While demographic trends will change spending for both Social Security and Medicare dramatically, the problem is likely to be more pronounced in Medicare due to the expected increases in health care costs per beneficiary. Medicare per capita spending is projected to vastly outpace the consumer price index for the next 25 years.

While it is true that the Hospital Insurance Trust Fund is projected to have a surplus over the next 10 years, it is misleading to focus so much attention on only one of the program's two trust funds, which represents only 60 percent of total Medicare spending. A full assessment of Medicare's finances reveals spending exceeds the total of tax receipts and premiums dedicated to Medicare today, and the "financing gap" is projected to widen dramatically. This annual gap was $59 billion in fiscal 2000, growing to an estimated $216 billion (using constant dollars) in 2020, and an estimated $368 billion in 2030. Additional information on the Medicare program can also be found in the Stewardship Information section of this *Financial Report*.

Economic and Budgetary Results

The economy slowed as fiscal 2001 began, and tipped into recession in March 2001, according to the National Bureau of Economic Research, the official arbiter of cyclical turning points. Despite the downturn, the fundamental strengths of the U.S. economy remained intact, and productivity continued to grow even as output declined. Fiscal and monetary policies were put in place to stimulate the faltering economy and promote long-term growth. Those factors probably contributed to keeping the recession mild, and a recovery appeared to take hold in the first quarter of fiscal 2002. Budget results for fiscal 2001 were still very favorable, as the Federal Government recorded the second largest budget surplus in history and paid down $90.1 billion in debt. However, the effects of the weak economy and the spending requirements following the September 11 terrorists' attacks are expected to lead to a budget deficit in fiscal 2002.

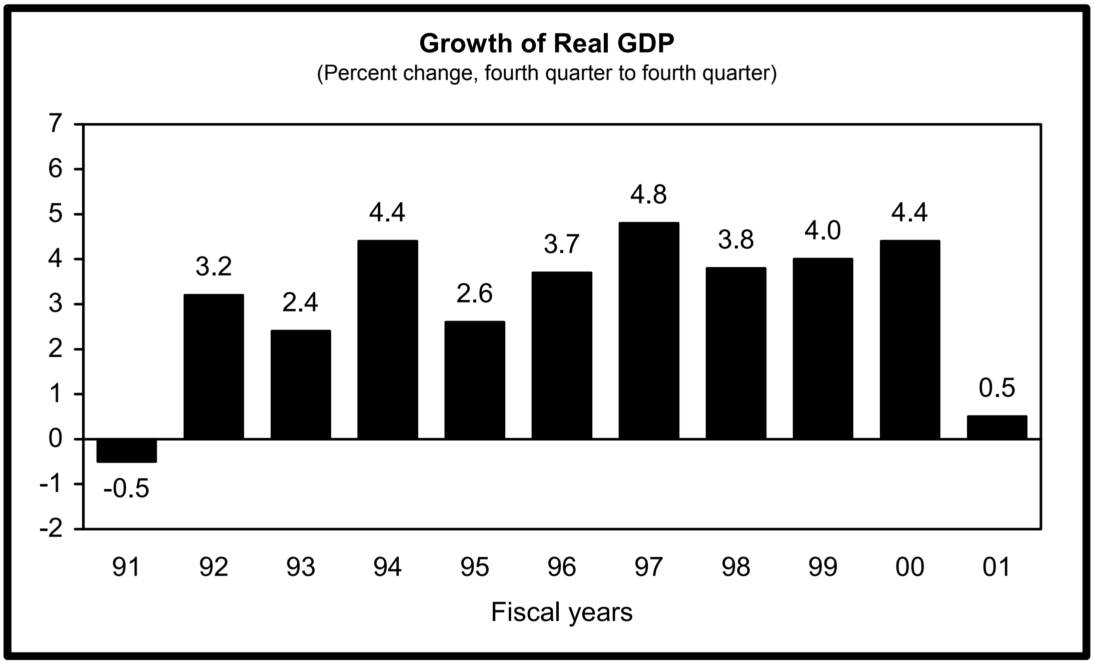
Budget Results

The U.S. fiscal situation continued to be favorable in fiscal 2001, although the deteriorating economy held the budget surplus below the level that had been projected in the April *Budget* and in the August *Mid-Session Review*. The unified budget was in surplus by $127.0 billion in the fiscal year, the second largest budget surplus on record. Receipts decreased by $34.1 billion or 1.7 percent, and eased to 19.6 percent in relation to gross domestic product (GDP) from a near-record 20.8 percent in the previous fiscal year. Outlays grew by $75 billion or 4.2 percent and represented an 18.4 percent share of GDP, unchanged from the previous year. The growth in outlays was less than the 5.1 percent increase registered in fiscal 2000.

The budget surplus allowed Federal debt held by the public to be paid down again in fiscal 2001 for the fourth year in a row. Debt was reduced by $90.1 billion, the second largest reduction in history. In relation to GDP, publicly held debt fell to 32.7 percent, down from 35.0 percent in the previous year and the lowest in nearly 20 years.

The Economy in Fiscal 2001

The economic slowdown that began in the final July-to-September quarter of fiscal 2000 turned into a recession during fiscal 2001, aggravated by the after-effects of the tragic September 11 events. Growth in real GDP diminished from a 1.9 percent annual rate increase in the first quarter of the fiscal year to a 1.3 percent decline by the fourth quarter. Over the four quarters of the fiscal year, GDP rose just 0.5 percent, the smallest gain since the last recession year in 1991 and much lower than the average 4.3 percent increase over the prior 4 fiscal years (see chart below).



Slower consumer spending and a contraction in demand for investment goods after extremely rapid growth in prior years were some of the factors contributing to the recession. Employment conditions weakened in the face of slack demand. Just 184,000 payroll jobs were added to the economy in fiscal 2001, compared to 2.6 million in the previous fiscal year. Much of the deterioration was in the manufacturing sector, where almost 1 million payroll jobs were lost over the fiscal year. The unemployment rate rose from 3.9 percent at the start of the year to 5.0 percent by the final month.

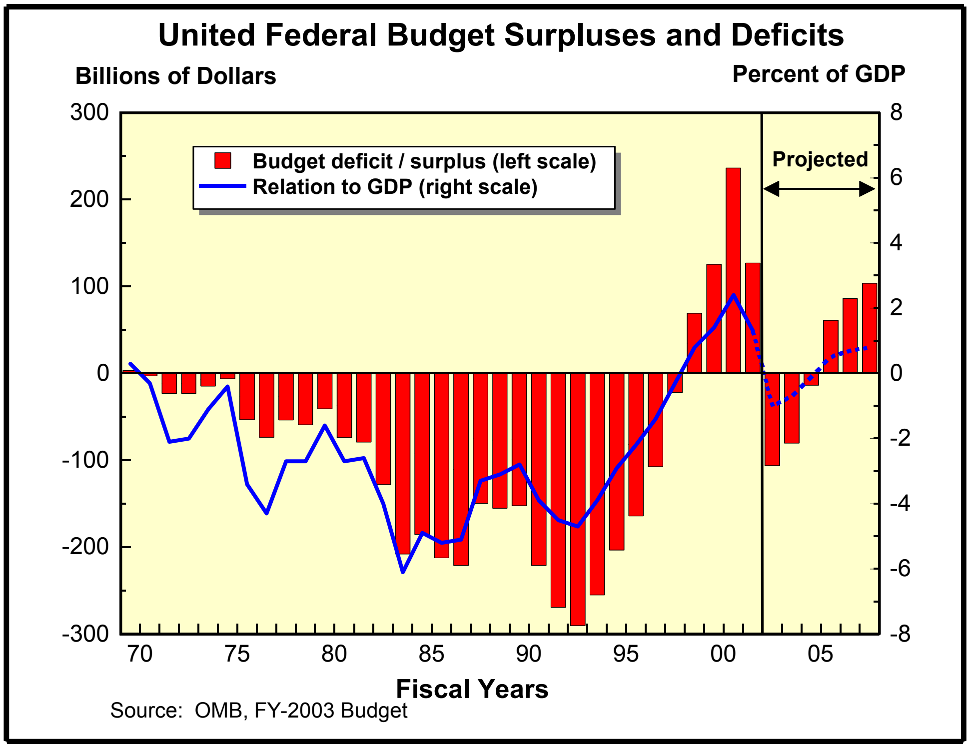
On the positive side, falling energy prices kept inflation well contained in fiscal 2001. Petroleum prices dropped nearly 25 percent over the fiscal year, holding the increase in the consumer price index to 2.6 percent, compared with 3.5 percent during the previous fiscal year when energy prices increased. Excluding energy and food, growth in "core" consumer prices was also moderate in fiscal 2001.

Fiscal policy measures were put in place last year that helped to offset some of the effects of the weakening economy. The Economic Growth and Tax Relief Reconciliation Act of June 2001 reduced individual income taxes by $1.35 trillion over 11 years, and some provisions were made retroactive to January 2001 in order to get rebate checks back to taxpayers quickly to help invigorate the economy. Additional spending initiatives in the wake of the September 11 attacks provided further assistance to get the economy back on track.

The Federal Reserve took timely action through the fiscal year in order to promote stronger economic growth, lowering short-term interest rates eight times. The targeted Federal funds rate (the rate that banks and other financial institutions charge one another for overnight loans) was reduced from 6.5 percent at the start of the fiscal year to 3.0 percent by fiscal year-end. The Federal Reserve lowered the discount rate (the rate the Federal Reserve charges banks for short-term funds) from 6.0 percent in the first month of the fiscal year to 2.5 percent by the end of the fiscal year. The Federal Reserve continued to cut interest rates in the first quarter of fiscal 2002 to levels not seen since the early 1960s, but decided in the second quarter to leave rates unchanged.

Budget Projections

The economic recession in fiscal 2001, tax cuts and other stimulus measures to promote growth, and the spending requirements of the war on terrorism and homeland security are expected to lead to a unified budget deficit of $106 billion for fiscal 2002. Budget deficits are projected to narrow in the following two years, however, and the budget is expected to return to surplus by fiscal 2005. Over the 10 years from fiscal 2002 to fiscal 2011, the cumulative budget surplus under the current services baseline (i.e., with no changes to tax and spending laws already enacted) is expected to total $2.2 trillion.



Significant Performance Accomplishments

Progress on Audited Financial Statements

Results of FY 2001
Agency Financial Audits

Improvement
Clean: DOJ, DOT
Qualified: Education
Disclaimers: USDA, USAID

Unchanged
Clean: Commerce, Energy, HHS, HUD, DOI, DOL, State, Treasury, VA, EPA, GSA, NRC, NSF, OPM, SBA, SSA
Disclaimer: DOD

Deterioration
Qualified: FEMA
Disclaimer: NASA

For the second time, in fiscal 2001, all of the 24 largest agencies met the deadline for completing and submitting their audited financial statements. Eighteen agencies received clean opinions and five showed marked improvement. The Departments of Justice and Transportation moved from qualified to clean opinions. Other areas of improvement included the Federal Aviation Administration, an item on GAO's High-Risk list, which has cured many of its financial management weaknesses. At the Department of Agriculture, three of five major agency components received clean opinions on their financial statements. For the first time, all Agency for International Development statements were audited, and three of five received qualified opinions. The Department of Defense, which again received a disclaimer, has launched a major initiative to improve its business and financial processes and systems. Two agencies, the National Aeronautics and Space Administration and the Federal Emergency Management Agency, deteriorated from last year, but have initiated ambitious programs to reclaim their clean opinions. In addition, the Administration has taken a number of steps to improve the accuracy and timeliness of Government financial information, beginning in fiscal 2002. These include accelerating the delivery of audited statements; the implementation of quarterly versus yearly reporting; displaying financial information from the current year with the previous year's; improving financial management systems; and requiring the integration of accountability reports with performance reports produced under the Government Performance and Results Act.

Expanding the question from "How much?" to "How well?"

The Federal Government has taken a significant step on the long road to a results-oriented Government by beginning to use performance measures to develop policies, to make budget decisions, and to improve everyday program management. The goal is to create a Government that promotes the outcomes that Americans want—such as better education for our children, the freedom to travel safely, and protection of our health—and does this in a cost-effective and efficient way. Achieving better program performance—particularly better performance for each dollar spent—is a high priority of this Administration. Congressional interest, reflected in the Government Performance and Results Act of 1993, set agencies to identifying performance goals, planning to achieve them, and reporting on results. What has been missing is systematic use of these measures to make decisions. In particular, performance measures are not directly linked to the budget—and yet it is the budget that drives policy development, allocates resources, and has undeveloped potential to support better management.

To address this disconnect, the President's Budget for 2003 seeks to inaugurate an era of accountability in the conduct of the Nation's public business. It takes the first step toward reporting to taxpayers on the relative effectiveness of the thousands of purposes on which their money is spent. It commences the overdue process of seriously linking program performance to future spending levels. It asks not merely "How much?"; it endeavors to explain "How well?"

To develop the President's Budget for 2003, OMB and agencies collected evaluations, studies, and performance documentation of multiple sorts from all sources to assess which programs were effectively improving desired outcomes. Within the Executive Branch, preliminary assessments of these materials were discussed, and agencies were urged to improve program performance and to improve evidence of effectiveness and linkage with program cost. Below are some of the results of this performance-oriented process of policy development and budget allocation. The examples illuminate ways in which policy makers and program managers can help Government better serve its citizens.

- **Agriculture**: Numerous Government and private studies show that the Special Supplemental Nutrition Program for Women, Infants and Children (WIC) is one of the Nation's most successful and cost-effective early intervention programs. The program saves lives and improves the health of women, infants and children who are nutritionally at risk. The Budget reflects this demonstrated success by fully funding the program in 2003 to enable all eligible persons who seek services to receive them. The request is sufficient to provide 7.8 million persons with supplemental foods, nutrition education, and preventive health care each month in 2003.
- **Commerce:** The National Weather Service, an effective program, got an increase in funding and specific targets to increase hurricane warning lead time from 24 hours in 2002 to 28 hours in 2005, increase tornado lead time from 10 minutes today to 22 minutes by 2015, improve aviation forecasting accuracy by 13 percentage points by 2007, and improve temperature and river forecasts for a pilot region by 2004. Lives will be saved by more timely evacuations; airline and energy industry costs and energy use will be reduced. The National Hurricane Center achieved its most recent critical success when it correctly forecast that the brunt of dangerous Hurricane Michelle would just miss the Florida peninsula. Accurate forecasts of hurricane tracks translate to smaller areas required to prepare for evacuation, saving approximately $1 million per mile for coastal residents, businesses, and local governments.

- **Health and Human Services:** Funding for the National Institutes of Health, the world's leading research institution for biomedical and behavioral research, will increase to double its 1998 level. NIH conducts research in its own laboratories, but the vast majority of its funding supports researchers in universities, hospitals, and research institutes around the country through peer-reviewed grants. NIH has supported great advances in the detection and treatment of disease, and its recent work on the human genome, cancer, and many other diseases gives promise of accelerating breakthroughs.
- **Labor/Training:** This Budget begins a wide-ranging reform of Federal investments in training and employment. In 2002, there are at least 48 overlapping training and employment programs scattered around 10 agencies. For several programs that are duplicative or have a history of poor performance, funding is reduced or terminated, reducing the number of programs from 48 to 28. For the many other training programs where performance measures are inadequate or not comparable, a multi-year effort will begin to assess relative effectiveness, shift resources to programs that prove effective, and eliminate ineffective or duplicative programs.
- **National Science Foundation:** The NSF, a leader among Federal agencies that fund basic research, will get more funding and programs transferred from other agencies. Of NSF's grants, 94 percent are competitive, based on merit review. Each year, one-third of NSF's research and educational programs are evaluated for integrity, efficiency, and quality of results, so that all programs are reviewed in a three-year period. Of the dozen 2001 Nobel Prize winners in the sciences, NSF supported eight for the research that won them the award. NSF quickly redirects resources to areas of emerging opportunity, and invests one quarter of its research budget in areas where major breakthroughs are likely.
- **Social Security Administration:** SSA has targeted an increase in retirement claims processed within 14 days from 84 percent in 2001 to 87 percent by 2003, an increase in customer initiated services available electronically from 21 percent to 40 percent, and an increase in callers access to SSA's 800 number within five minutes of their first attempt from 92 percent in 2001 to 94 percent in 2003.

Looking to the Future: The President's Management Agenda

The President has called for a Government that focuses on priorities and executes them well. Securing the homeland, waging war on terrorism abroad and revitalizing the economy are the most important priorities, but even they will not be addressed by simply devoting money to them.

The assumption that more Government spending gets more results is not always true but is seldom tested. It is potentially wrong for two reasons. First, the program may not actually achieve the results everyone expects. Second, it ignores the fact that improvements in the management of programs can result in greater results for less money by realizing the same productivity gains found in the private sector. By focusing on performance, we can achieve the desired results at limited additional cost or, in some cases, a reduction in spending. We can all get more for less.

The President has ordered the pursuit of five Governmentwide initiatives that together will help Government achieve better results. These initiatives include strategic management of human capital, competitive sourcing, improved financial performance, expanded electronic Government, and the integration of budget with performance. Released in August 2001, the President's Management Agenda was designed to "address the most apparent deficiencies where the opportunity to improve performance is the greatest." The President's vision is guided by the principles that Government should be results-oriented, not process oriented; citizen-centered, not bureaucracy-centered; and market-based, promoting competition rather than stifling innovation.

The President's Agenda is a coordinated and coherent strategy to reform Federal management and improve program performance. It tackles long-neglected management problems and offers specific solutions to fix them. Five Governmentwide initiatives apply to every department and agency. Together they form a strategy to achieve breakthrough, not simply marginal, improvements in program performance.

The Human Capital Initiative aims to attract and retain talented and imaginative people into the Federal Government in order to improve the service provided to our citizens. The Competitive Sourcing Initiative exposes parts of the Government to competition so that they may better focus on what customers want while controlling cost. The Financial Management Initiative improves how the Government manages its money – reducing, for instance, the billions in erroneous payments the Government makes every year. The E-Gov Initiative harnesses the power of the Internet to make the Government more productive. The Budget Performance/Integration Initiative starts the process of linking results with resource decisions – the underlying information needed to hold Government accountable.

Keeping Score

Good intentions and good beginnings are not the measure of success. What matters in the end is completion: performance and results. Not just making promises, but making good on promises.

In order to ensure accountability for performance and results, the Administration is using an Executive Branch Management Scorecard. The Administration will use this scorecard to track how well departments and agencies are executing the management initiatives, and where they stand at a given point in time against the overall standards for success.

The scorecard employs a simple “traffic light” grading system common today in well-run businesses: green for success, yellow for mixed results, and red for unsatisfactory. Scores are based on five standards for success defined by the President’s Management Council and discussed with experts throughout Government and academe, including individual Fellows from the National Academy of Public Administration.

The National Science Foundation (NSF) received the only “green” score. NSF did so in financial management because it has embraced advanced information technologies and operates in a paperless environment. Its grant workload more than doubled from $2.1 billion in 1990 to $4.4 billion in 2000, yet the number of employees actually decreased.

The initial scorecard shows a lot of poor scores. This was to be expected since, as the President indicated when selecting the Management Agenda items, the areas are “targeted to address the most apparent deficiencies where the opportunity to improve performance is the greatest.” The marks that really matter will be those that record improvement, or lack of it, from these starting points.

Executive Branch Management Scorecard
2001 Baseline Evaluation

	Human Capital	Competitive Sourcing	Financial Management	E-Gov	Budget/ Performance Integration
AGRICULTURE	R	R	R	Y	R
COMMERCE	R	R	R	Y	R
DEFENSE	R	R	R	R	R
EDUCATION	R	R	R	R	R
ENERGY	R	R	R	R	R
EPA	R	R	R	Y	Y
HHS	R	R	R	R	R
HUD	R	R	R	R	R
INTERIOR	R	R	R	R	R
JUSTICE	R	R	R	R	R
LABOR	Y	R	R	Y	R
STATE	R	R	R	R	R
TRANSPORTATION	R	R	R	R	Y
TREASURY	R	R	R	R	R
VA	R	R	R	R	R
AID	R	R	R	R	R
CORPS OF ENGINEERS	R	R	R	R	R
FEMA	R	R	R	R	R
GSA	R	R	Y	R	R
NASA	R	R	Y*	R	R
NSF	R	R	G	Y	R
OMB	R	R	R	R	R
OPM	Y	R	R	Y	R
SBA	R	R	Y	Y	Y
SMITHSONIAN	R	R	R	Y	R
SSA	Y	R	Y	Y	R

*As a result of the disclaimer on NASA's fiscal 2001 financial statements, NASA will now move to red.

LEGEND: R = Red Y = Yellow G = Green

Over time, the scores should improve as departments and agencies correct the problems. The Administration will update this report twice a year and issue a mid-year report during the summer. This Administration will not indulge in grade inflation; we will hold ourselves responsible and report honestly when progress is too slow.

Systems, Controls, and Legal Compliance

Systems

The Federal Government faces agency-specific and Governmentwide challenges in modernizing its financial management systems. Many financial management systems need upgrading or replacing before they can provide information to support efforts to achieve the President's goal of a citizen-centered, results-oriented, and market-based Government.

The success of financial systems modernization efforts is dependent, in part, on standardized financial management across the Government. Towards this end, OMB, Treasury, and the Joint Financial Management Improvement Program (JFMIP) have been working together to better clarify and achieve consistency of standards for financial systems. In addition, OMB and Treasury are working together to develop a definitive set of information requirements that will ensure Governmentwide reporting requirements can be met through routine processes and system functions.

Controls

Numerous internal controls exist over Federal assets. Instances where these controls are not functioning as planned are described in the individual agency financial reports. Those deficiencies that materially affect the Governmentwide financial statements are described in the accompanying report prepared by GAO. Each agency is responsible for developing and implementing a corrective action plan. In addition, OMB and the Department of the Treasury will continue to work with Federal agencies to resolve crosscutting issues. In some cases, however, the resolution of these issues will require reengineering of current processes, which is currently being addressed.

Federal agencies have identified approximately $19 billion in annual erroneous benefit and assistance payments in just 13 Federal programs. The Administration has launched an initiative to determine and track error rates in additional programs, and to implement strategies and controls to bring the rates down in programs covering over $1.2 trillion in annual expenditures.

Legal Compliance

Federal agencies are required to comply with a wide range of laws and regulations, including appropriations, employment, health and safety, and others. Responsibility for compliance primarily rests with agency management; compliance is addressed as part of agency financial statement audits. Agency auditors tested for compliance with selected laws and regulations related to financial reporting. These auditors found no instances of material noncompliance that affected the Governmentwide financial statements. There were, however, instances that were material to an individual agency, and these were reported in the individual agencies' financial statement audit reports.

Basis of Accounting and Reporting Entity

Accounting Standards

The accompanying financial statements were prepared based on Generally Accepted Accounting Principles (GAAP) standards developed by FASAB, except as noted in our auditor's report.

GAAP for the Federal Government is tailored to the U.S. Government's unique characteristics and special needs. For example, the stewardship section of this report contains important information about diverse subjects such as land set aside for the use and enjoyment of present and future generations, heritage assets, weapon systems, and social insurance programs such as Social Security.

In fiscal 2001, two new financial statements were added at the Governmentwide reporting level: Reconciliations of Net Operating Revenue/(Cost) to the Budget Surplus (Unaudited) and Dispositions of the Budget Surplus (Unaudited). Both statements are unaudited for fiscal 2001, since they are not required by FASAB standards. FASAB is in the process of finalizing the format and content of these statements.

In addition, the presentation of the Statements of Net Cost has changed for fiscal 2001. The Statements now reflect the cost incurred to carry out the national priorities identified by the President and the Congress, and are shown by major agency or entity. Previously, net cost was shown by function.

Also, the Statement of Federal Financial Accounting Standard (SFFAS) No. 10 (Accounting for Internal Use Software) was implemented in fiscal 2001 at the Governmentwide reporting level. Under the provisions of this standard, internal use software is classified as "general property, plant and equipment" as defined in SFFAS No. 6 (Accounting for Property, Plant and Equipment).

Accrual Basis

GAAP requires that these financial statements be prepared using the accrual basis of accounting, but permits the use of modified cash accounting for taxes and duties. Under the accrual basis, transactions are reported when the events giving rise to the transactions occur, rather than when cash is received or paid (cash basis). Therefore, expenses are recorded when incurred, exchange revenue is recorded when earned, and taxes and duties (the majority of nonexchange revenue) are recorded on a modified cash basis of accounting (generally when received). In contrast, Federal budgetary reporting is generally on the cash basis in accordance with accepted budget concepts.

The most significant difference between these two bases involves the timing of recognition and measurement of revenues and costs. For example, GAAP requires recognition of liabilities for costs related to environmental cleanup when the events requiring such costs occur and, among other things, the Government has acknowledged responsibility for the event. By contrast, current budget concepts recognize such costs later, at the time payment is made for the cleanup. The differences are reflected in the Reconciliations of Net Operating Revenue/(Cost) to the Budget Surplus (Unaudited), which can be found in the Financial Statements section of this Financial Report.

Coverage

These financial statements cover the executive branch, as well as parts of the legislative and judicial branches of the U.S. Government. A list of the significant entities included in these financial statements is in the Appendix. Information from the legislative and judicial branches is limited because those entities are not required by law to submit comprehensive financial statement information to Treasury. Due to its private ownership and independence, the Federal Reserve System is excluded. In addition, Government-sponsored but privately owned enterprises (such as Federal Home Loan Banks and the Federal National Mortgage Association) also are excluded.

Additional Information

Additional details about the information contained in these financial statements can be found in the financial statements of the individual agencies listed in the Appendix. In addition, related U.S. Government publications such as the *Budget of the United States Government*, the *Treasury Bulletin*, the *Monthly Treasury Statement of Receipts and Outlays of the United States Government*, the *Monthly Statement of the Public Debt of the United States*, the *Economic Report of the President*, and the Trustees' reports for the Social Security and Medicare programs may be of interest.

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