

# Debt, deficits and recovery

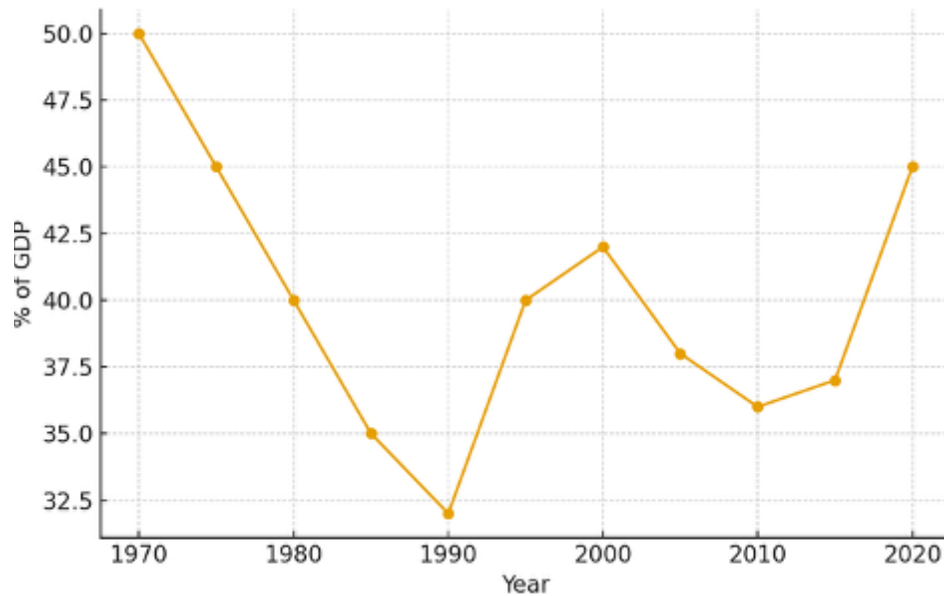
## Navigating post-Covid-19 fiscal challenges

In this article, **Hannah Holmes** explores how government debt ballooned after the pandemic, why deficits matter, and the trade-offs facing policymakers. The UK's post-Covid-19 story, from emergency borrowing to the mini-budget crisis, illustrates the dilemmas of managing public finances in turbulent times.

The Covid-19 pandemic was an economic earthquake. In March 2020, shops shut, flights were grounded, and millions of workers were told to stay at home. To prevent mass unemployment, the UK government launched the furlough scheme, paying up to 80% of wages for employees who could not work. Loans, grants and welfare measures followed, alongside vast spending on testing, vaccines and healthcare.

The price tag was extraordinary. UK borrowing reached nearly 15% of GDP in 2020, the highest since the Second World War. Across the advanced world, fiscal balances collapsed as governments prioritised survival over spreadsheets.

By 2022, UK public debt stood at around 100% of GDP, the highest in over half a century. Figure 1 shows this striking jump, set against decades of lower ratios.



Source: ONS

Figure 1 UK public sector net debt as % of GDP, 1970–2023

## What are deficits and debt?

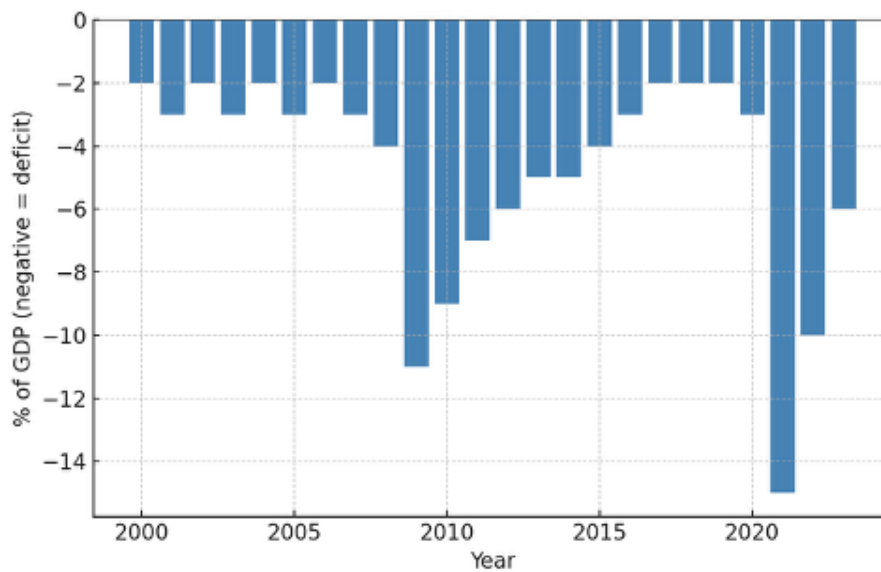
The deficit is the annual gap between what a government spends and what it raises in revenue. Debt is the stock of past borrowing, accumulated over time.

Keynes argued that deficits in recessions are not only acceptable but necessary. Borrowing to support demand prevents deeper slumps and long-term damage. When growth returns, governments can stabilise debt by raising taxes or cutting spending.

But persistent borrowing creates risks. Classical economists warn of crowding out: when the government borrows heavily, it soaks up savings that firms might otherwise invest,

pushing up interest rates. Others point to intergenerational fairness: today's borrowing may leave tomorrow's taxpayers with the bill.

Figure 2 tracks the UK's budget deficit since 2000, showing how Covid-19 dwarfed earlier spikes such as the 2008 financial crisis.



Source: ONS

Figure 2 UK public sector net borrowing as % of GDP, 2000–2023

## History lessons

Britain has faced mountainous debts before. After the Second World War, public debt exceeded 250% of GDP. Yet rather than crushing the economy, this debt was gradually reduced.

Part of the answer was growth. Reconstruction spurred demand, trade expanded under the new Bretton Woods system, and productivity rose as industry modernised. Marshall Aid from

the USA injected funds, while nationalisations and investment in housing and infrastructure rebuilt the economy.

Moderate inflation also helped. Prices rising faster than interest rates eroded the real value of debt. Economists call this financial repression: keeping interest rates low while allowing inflation to reduce the burden.

Importantly, Britain did not slash public spending. The postwar years saw the creation of the NHS, expansion of secondary education, and new welfare systems. High debt did not stop social investment. By the mid-1970s, the debt ratio had fallen below 60%.

## The austerity decade

After the 2008 global financial crisis, debt rose sharply again, though not to post-war levels. The political response was different. From 2010, Chancellor George Osborne pursued austerity: deep cuts to departmental spending, a public sector pay freeze, reductions in welfare benefits, and higher tuition fees for students.

Supporters argued that austerity restored credibility, reassuring investors that the UK would not spiral into crisis like Greece. Critics countered that it slowed recovery, suppressed productivity growth, and worsened inequality. Public services were stretched: NHS waiting lists lengthened, local government cut libraries and youth services, and wages stagnated in real terms.

For A-level students, the austerity decade illustrates the trade-off between stabilising debt and supporting growth. Economists still debate whether the cure was worse than the disease.

## The mini-budget crisis of 2022

If 2020 was about borrowing to save the economy, 2022 was about what happens when confidence is lost.

In September that year, the government unveiled a ‘mini-budget’: sweeping, unfunded tax cuts coupled with vast energy subsidies. Markets panicked. Investors feared the UK was borrowing recklessly at a time of high inflation and rising interest rates.

Within days, gilt yields, the interest rates on UK government bonds, surged to levels not seen in decades. The pound slumped to record lows against the dollar. Pension funds, which had invested heavily in liability-driven investment (LDI) strategies tied to gilts, suddenly faced huge collateral calls. To raise cash, they sold gilts, driving prices down further in a vicious spiral.

The Bank of England stepped in with emergency bond purchases to prevent systemic collapse. Within weeks, most of the tax measures were abandoned, and political leadership changed.

This episode showed that debt is not just about arithmetic but credibility. Markets can turn suddenly, punishing policies they see as unsustainable.

## Global perspectives

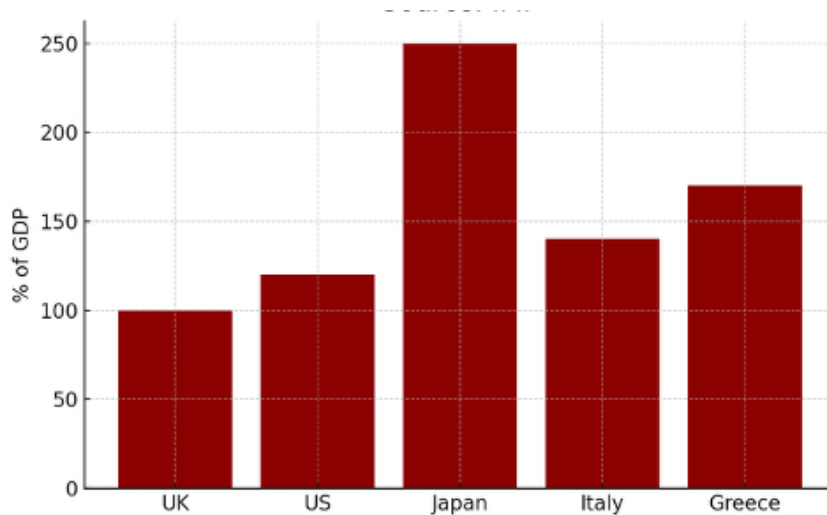
The UK was not alone in its borrowing surge.

**USA:** Federal debt hit around 120% of GDP. Political fights over the ‘debt ceiling’ became more fraught, raising the risk of government shutdowns. Yet US Treasury bonds remain the world’s safe haven, giving Washington more breathing space.

**Japan:** Debt exceeds 250% of GDP, yet markets remain calm. Most is held domestically, and the Bank of Japan has bought huge volumes of bonds to keep interest rates ultra-low. Japan shows that context matters: high debt is not always a crisis.

**Eurozone:** Countries like Italy (140% debt/GDP) and Greece (over 170%) face stricter market discipline. Greece's crisis from 2010 onwards showed the dangers of losing investor confidence. Borrowing costs soared, and Greece required bailouts from the EU and IMF. In return, it accepted tough austerity conditions from the 'Troika'. Pensions were cut, taxes raised, and unemployment soared above 25%, with youth unemployment exceeding 50%. The social costs were immense.

Figure 3 compares debt-to-GDP across economies in 2023, showing the UK's place in the pack.



Source: IMF

Figure 3: General government gross debt as % of GDP, 2023

## Theoretical debates

Economists remain divided about how much debt is ‘too much’.

Keynesians stress the multiplier effect: borrowing boosts demand, preventing deeper downturns, and can make debt more manageable as GDP grows.

Classical economists warn of crowding out, especially if borrowing pushes up interest rates. Example: if the government borrows £20 billion, businesses may face higher rates on loans, reducing investment.

Ricardian equivalence claims deficits may not stimulate at all, if households save tax cuts to pay future bills. Example: a £100 tax rebate is saved, not spent, so demand does not rise.

Debt sustainability rule ( $r < g$ ): as long as the economy grows faster ( $g$ ) than interest costs ( $r$ ), debt can be stable. This was true in the 2010s, when growth outpaced ultra-low rates. In the 2020s, with higher rates, the balance is less favourable.

Modern Monetary Theory (MMT) argues that sovereign issuers of currency cannot go bankrupt, inflation is the real limit. Critics respond that markets can still demand credibility, as the mini-budget showed.

These debates are not abstract. They frame real policy dilemmas in the UK and beyond.

## Who pays?

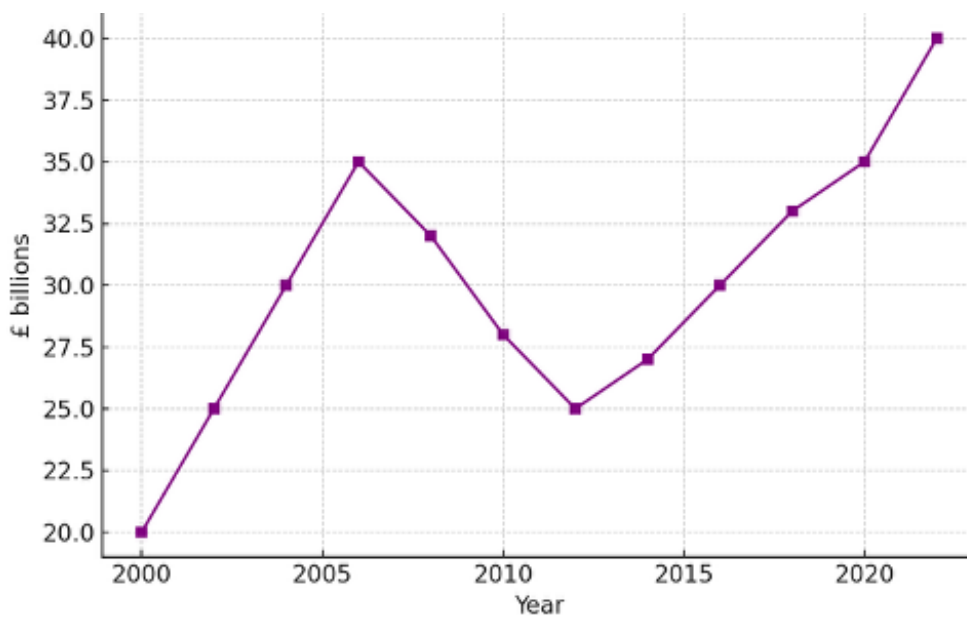
Debt is not just an economic statistic; it shapes fairness between groups.

**Taxpayers:** Higher debt can mean higher taxes, either directly or through frozen thresholds that pull more people into higher bands.

**Future generations:** Borrowing today may shift burdens forward. Yet if debt funds investments like green energy or better infrastructure, tomorrow’s citizens may inherit benefits, not just costs.

**Public services:** Rising debt interest is money not spent on hospitals, schools or welfare. In 2022–23, the UK spent more servicing debt than on education.

Figure 4 shows the rise in debt interest payments since 2000, spiking as inflation lifted the cost of index-linked gilts.



Source: ONS

Figure 4: UK government debt interest payments, 2000–2023

## Long-term pressures

Beyond Covid-19, deeper pressures loom.

**Ageing populations:** The Office for Budget Responsibility projects that by 2070, pension, health and social care costs will rise by over 5% of GDP, equivalent to more than £100 billion in today's money. With fewer workers per retiree, the tax base will struggle to keep up.

**Climate transition:** The Climate Change Committee estimates that reaching net zero will require £50–60 billion a year in combined public and private investment. Governments will need to shoulder a significant share, particularly in green infrastructure and innovation.

**Geopolitics:** Russia's invasion of Ukraine and tensions with China suggest higher defence spending ahead. NATO commitments already require 2% of GDP; pressure is growing for more.

Debt will not fall on its own. Choices must be made about taxation, spending and growth.

## Policy dilemmas today

Policymakers face unenviable trade-offs:

**Support growth vs control debt:** Too much consolidation risks recession; too little risks market backlash.

**Monetary–fiscal coordination:** The Bank of England raises rates to fight inflation, but if fiscal policy is too loose, it undermines this. The mini-budget crisis was a textbook clash.

**Credibility vs flexibility:** Markets demand discipline, but rigid austerity can undermine social cohesion. The 2010s showed the risks of deep cuts to services.

Possible strategies include reforming property and wealth taxes, broadening the tax base, prioritising investment over day-to-day spending, and raising productivity to grow the denominator of the debt ratio.

## Conclusion

The pandemic pushed government debt to levels not seen in decades. Emergency borrowing saved jobs and businesses, but it left a heavy legacy. The UK's mini-budget crisis of 2022 showed how fragile market confidence can be when debt is high and credibility falters.

Yet history shows debt can be managed. After the Second World War it was reduced by growth and inflation, in the 2010s by austerity, and in Japan by domestic financing and low rates. The right path depends on context and choices.

For A-level students, the debt story is a live case study in economics. Theories like Keynesian multipliers, crowding out, Ricardian equivalence and the  $r < g$  rule are not just classroom concepts, they explain the world outside. At the same time, the politics of debt remind us that economics is about values: how costs are shared between generations, and what kind of future societies choose to build.

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### Key points

- UK debt surged to ~100% of GDP after the pandemic, the highest in decades.
- Borrowing saved jobs and prevented collapse but left a lasting legacy.
- The 2022 mini-budget crisis showed how fragile market confidence can be.

- Debt interest costs now rival major public service budgets.
- Long-term pressures include ageing, net zero investment and defence.

models.

### Specification links

public finances; policy conflicts and trade-offs