states to improve the welfare of the latter's citizens;

- the allocative function, which supplements the inadequate capital investment in poorer countries that the private sector provides (see Figure 3). The RR' axis is the minimum tolerable rate of return on investment and XX' is the actual (ex post) rate of return. MM' is the minimum (ex ante) rate of return anticipated by private investors. OA is the quantity of private investment based on pessimistic assumptions about risk. Learning by doing and human capital formation will lead to MM' and XX' rising over time (elements of endogenous growth theory here). Thus, richer governments can augment investment available to poorer countries, which in time will lead to more accurate assessments by private investors; and

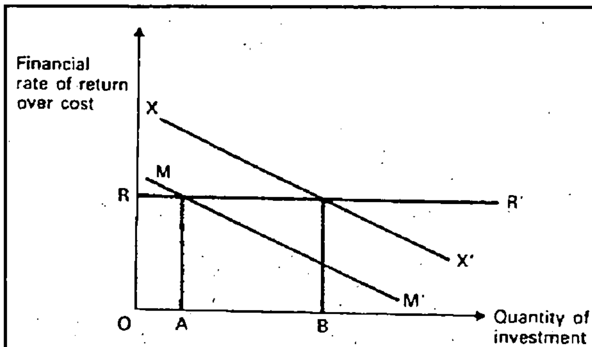

Figure 1.1: Allocation arguments for overseas aid

Figure 3

- the stabilisation function, which argues that aid flows can raise total systemic demand, relieve unemployment and ultimately increase total trade flows, while at the same time hopefully improving the potential for more responsible government in the recipient country.

This taxonomy is consistent with our earlier theoretical analysis of the macroeconomic contribution of aid, which in turn fits into the discussion of endogenous growth. Aid can lead to increased investment in both physical and human capital, which leads to increasing returns to scale of inputs. As noted in the section on innovation, aid can also fulfill a role in transferring technology to maintain the "endogenous engine" of growth.