



# Is Social Europe Fit for Globalisation?

*A study on the social impact of globalisation in the European Union*

## *Executive summary*

### **Partner Institutes:**

Centre for European Policy Studies (CEPS), Brussels, Lead Contractor

### **With participation from:**

Fondazione Rodolfo Debenedetti, University of Bocconi, Milano

Deutsches Institut für Wirtschaftsforschung (DIW), Berlin

University of Nottingham, Nottingham

TARKI Social Research Centre, Budapest

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**Authors:**

Iain Begg, Visiting Professor, London School of Economics

Juraj Draxler, Research Fellow, Centre for European Policy Studies

Jørgen Mortensen, Associate Senior Research Fellow, Centre for European Policy Studies

**Contributors**

This final report includes extracts from and interpretations of the following contributions submitted by associated experts:

János Gács, (Institute of Economics of the Hungarian Academy of Sciences): *Comparative analysis of economic openness of old and new Member States*

Juraj Draxler (CEPS): *Globalisation and social risk management: A literature review*

Holger Görg, Ingo Geischecker and Sara Maioli (University of Nottingham): *The impact of outsourcing on labour markets*

Ingo Geischecker and Holger Görg (University of Nottingham): *The effect of outsourcing on wages*

Ingo Geischecker and Holger Görg (University of Nottingham): *Winners and losers*

Hella Engerer and Mechthild Schrooten (DIW): *Globalisation and migration*

Ioannis Cholezas (Athens University of Economics and Business and Centre for Planning and Economic Research – KEPE) and Panos Tsakloglou (Athens University of Economics and Business, Institute for the Study of Labour – IZA): *The socioeconomic impact of immigration to Greece*

Margarita Katsimi and Panos Tsakloglou (AUEB): *The socioeconomic impact of globalisation in Europe: policy implications*

Tito Boeri and Michele Pellizzari (fRDB): *Reforms in the field of migration*

István György Tóth (TARKI): *Income inequalities, poverty and precariousness in the globalising Europe*

Márton Medgyesi (TÁRKI): *Globalisation, growth and regional inequality in Europe*

George Pagoulatos (AUEB) and Myrto Stasinopoulou (AUEB and University of Oxford): *Governance in EU social and employment policy: A survey*

# Is social Europe fit for globalisation?<sup>1</sup>

## Executive summary

### *Key messages*

1. There can be little doubt that globalisation is having, and will continue to have, a pervasive influence on 21<sup>st</sup> century economic and societal developments. International flows of goods, services and capital have all increased substantially relative to output, especially over the last two decades. However, much of the increase in exposure to international competition confronting EU Member States is, in fact, the result of European economic integration.
2. An important aspect of globalisation is that the world's two most populous countries – China and India – have re-integrated into the world economy after decades of comparative isolation. Together with the re-integration of former communist countries in Europe, this has meant that the supply of labour available at the global level has greatly expanded, as has the number of global consumers and hence the size and diversity of the potential market for EU exporters.
3. Yet globalisation has to be seen in perspective. As a proportion of GDP, world trade reached a peak before the start of the First World War and it is only in the last decades that it has returned to these levels. As a proportion of population, international migration is still less extensive than it was one hundred years ago.
4. A distinctive feature of the present wave of globalisation is the intensity of (mostly, two way) capital flows, including foreign direct investment (FDI). Although for most OECD countries FDI still accounts for a relatively small proportion of overall investment, it is a key source of capital and know how for a number of developing countries, and has also been significant for some EU Member States such as Ireland. Asian investment in the richer countries also deserves to be highlighted.
5. At a deeper level, globalisation can be attributed to underlying drivers of economic, political and social change. They include the long march towards market liberalisation that has characterised the period since the 1950s, the collapse of communism, demographic developments and technological change. Advances in information and communication technologies have had a very pronounced effect on the organisation of economic activity, as have falling costs of transport, and technologies now flow across borders more readily and more rapidly. To illustrate the point, total freight costs for trade between developed countries now account for less than 4% of the value of trade: examples are that transport charges represent only 2% of the cost of a television shipped from Asia to Europe and 1.2% of the cost of a kilo of coffee. Similarly, at today's prices, a three minute phone call between New York and London would have cost US\$ 293 in 1931, US\$ 1 in 2001, and is now just a few cents - for a hugely better connection.
6. The process of globalisation, including its drivers and social consequences, is summarised and illustrated in figure 1 at the end of this summary. The main drivers (enablers) are on the left-hand side, various aspects of the globalisation process in the middle part and the

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<sup>1</sup> The views expressed in this document are those of the authors and do not necessarily represent those of the European Commission.

(potential) social consequences and the policy recommendation in this report on the right-hand side.

7. These trends have been associated with growing prosperity in aggregate, but it is clear that there are losers as well as winners. In particular, rapid advances in technology, coupled with adjustments in some global markets have exerted pressures on the returns to unskilled labour in Europe, with the falling relative wages of unskilled workers contributing to a widening of income inequalities. Against this backdrop there have been growing fears that the European social model, rightly seen as a defining feature of the European Union and its Member States, can no longer be sustained and that it will have to be reined-back or even dismantled.
8. A clear conclusion of this report is, however, that these fears are largely unfounded and that there is no compelling evidence that globalisation is leading inexorably to a 'race-to-the-bottom' in social policy or the capacity of European society to maintain its commitments to solidarity and equality.
9. The contemporary economic environment nevertheless calls for more rapid adaptation to shifting economic currents and fresh thinking about the role of social policy in meeting the challenges of adjustment to new sources of competition – whether due to technological change or the different manifestations of globalisation. Social policy has several roles to play in responding to this challenge, notably in facilitating adjustment in labour markets. Education is at the heart of adaptation, but solidarity cannot be neglected.
10. Some of the directions for policy development, such as placing greater weight on flexibility in labour markets and making social protection systems more responsive, are already receiving considerable attention. Others, such as dealing with the consequences of an ageing population are recognised as key challenges, but there is less evidence of coherence in policy responses. How to accommodate increased immigration has been less prominent on the policy agenda and has not always been viewed as the most urgent issues in many Member States, though it is rapidly becoming so. Consequently the development of new policy ideas can benefit from exchange of experience and learning from those Member States which have led the way in policy development and innovation.
11. We argue, further, that within the debate on flexicurity, it is especially important to look beyond the labour market emphasis of much of the discourse to embrace those wider aspects of the concept that bear most on the economically inactive and the excluded, and not to lose sight of the solidarity function of social protection.

### ***Definitions and overview of the study***

12. This study is concerned with the social impact of globalisation in the EU context. Consequently, it does not attempt to investigate the wider issues raised in work by, notably, the ILO about the costs and benefits for richer and poorer nations and social groups, nor the governance challenges raised by Joseph Stiglitz and others about sharing out prosperity at the global level. Instead, the study concentrates on the implications for social policies at EU and Member State levels. The study takes as a given that globalisation has a positive overall economic effect, but also that it has distributive consequences that mean that there will be losers as well as winners. It is also acknowledged that the benefits of globalisation do not necessarily accrue automatically to all Member States, but need to be nurtured by appropriate policy choices.

13. Globalisation is not an easy concept to pin down, as it has many facets and encompasses a wide range of different processes associated with increased inter-connectedness across national borders. A credible definition encompasses: the growth in international flows of goods, services and capital; the increased propensity to international migration; the spread of technologies and of the multinational companies that play a major role in diffusing them; and the intensification of communication exemplified by the expansion of internet use. Geographically more dispersed sub-contracting, sourcing, and division of labour in production processes are also associated with globalisation.
14. The study is in three main parts that draw on more detailed work produced by the research team responsible for the study. The first looks at the background, the facts and the figures about globalisation, with the objective of presenting a clear picture of what globalisation is and is not. In the second part, the focus is on the social dimension, including extensive documentation of EU social conditions, together with more specific work on migration (and the regulatory developments affecting it) and trends inequality. The third part of the study then concentrates on the policy challenges, starting with a discussion of policy issues, what they imply for social policy and the social agenda in the EU, and continuing with a scenario exercise that speculates on the likely evolution of globalisation. A summary and recommendations complete the study.

### ***Main findings on globalisation and its consequences***

15. Many contributors to the literature have sought to develop and refine definitions of globalisation, in theoretical and empirical terms. While intensity of trade is often used as a proxy for the globalisation process, most authors dealing with the contemporary global economy argue that globalisation should be viewed as a multi-dimensional phenomenon. Capital and currency flows are just as important as trade in providing quantifiable indicators of globalisation. Certain structural factors, for example the rise of intra-industry trade, and the growing salience of multinational enterprises (MNEs), should be added to the picture.
16. Defining features of the current phase of globalisation include the fact that the global market has expanded to an unprecedented scale and the weakening of the traditional core-periphery effects. The volume of world trade quadrupled between 1980 and 2005, while output rose by 250%. In the past, the core provided manufactured goods to the periphery in exchange for raw materials. Today, however, the emerging markets account for a large and growing share of world manufacturing capacity. Even more strikingly, the flow of capital has become bi-directional. While in the 19<sup>th</sup> century Britain exported financial capital to the periphery, the largest economy of today, the United States, runs a current account deficit substantially financed by emerging-economy nations.
17. In terms of explaining the behaviour of economies in the globalising world, traditional economic theories of trade based on comparative advantage struggle to explain actual developments in the world, particularly the rise of Asian economies, which created, rather than relied on existing, comparative advantages. China doubled its share of world trade in goods to 9% in the decade to 2005, not just by relying on cheap labour, but the EU has maintained its share, unlike the US and Japan.
18. While globalisation is an uncontested world-wide phenomenon, the rise in the degree of openness to trade in goods and services of the EU Member States has been much less pronounced than frequently argued in the media and in public discourse. The pace of openness to trade has not shown a striking acceleration, with the exception of Germany,

the Benelux countries and most of the recently-acceded Member States where openness to trade in goods has increased. However, the latter is mainly an effect of elimination of trade barriers within the enlarged Internal Market.

19. Moreover, the current geographic fragmentation of production processes also has no precedent in history and, in today's world, countries increasingly trade in tasks, rather than products. It is also salient that capital markets are much more mature today than at any time during the past expansions of trade and capital flows. Gross flows of capital are much larger than in the past, and they take many more forms. In particular the flows of foreign direct investment are much larger relative to output than at any time before.
20. During the last two decades, financial integration has been by far the most rapidly expanding field of globalisation. Both portfolio and direct investment have increased by a greater order of magnitude relative to GDP. For the 'old' EU Member States, volume indicators of international financial integration show a tenfold increase in the 35 years between 1970 and 2004. The stock of external assets and liabilities for the EU as a whole as a proportion of GDP rose from 59% of GDP in 1970, to over 550% in 2004, with a particularly strong expansion after 1995. As a result of more intense financial integration, the foreign influence on business has increased, including a substantial increase in control by foreign owners through majority-owned foreign affiliates. However, there has been a rise in both outward and inward FDI and there is no indication of an overall increase in foreign (non-EU) ownership of EU business.
21. There has been a considerable relocation of productive activities, in both goods and services. This has resulted in a rapid expansion in two-way trade flows between developed and developing economies. However, the EU has been among the winners, in particular in the field of business services, with, nevertheless, a substantial increase in the market share of India.
22. An analysis of the effect of relocation of activities supports the thesis that the outsourcing of activities during the last fifteen years has tended to lead to relative wage losses for unskilled workers and for branches employing a large share of unskilled workers. However, other studies reviewed underline sharply that rules and regulations concerning the functioning of the labour market and wage formation exert a large impact on the degree of outsourcing. There are large disparities between countries with respect to skill levels, which has the arithmetic effect that those countries with low average levels of skills tend to be most vulnerable. The effects of global competition manifest themselves either in stagnating real wages or (in case of rigidities with respect to wage formation) rising unemployment.
23. "Insourcing" of activities, that is, the expansion (notably of the export of business services and other high-value added service activities) in the world market for service industries have, as could be expected, mainly favoured the branches of activity relying on top-level high-skilled human resources and has, unavoidably, contributed to the rise in the wedge between high- and low-skilled labour. However, there is an off-setting trend for certain professional activities to be out-sourced to countries like India with lower cost, but well-educated workers.
24. Despite these various forms of relocation of economic activity, there is little sign that tax yields in EU countries are coming under pressure. Among the old Member States (EU-15) only Finland, Ireland and the Netherlands saw a substantial shrinkage of the relative size of their total tax revenues between the periods 1991-1995 and 2001-2005, comparable periods in the economic cycles. These developments, however, seem to be the results of

conscious structural reforms, rather than directly reflecting pressures from more mobile tax bases. Most of the EU-15 Member States either maintain the relative size of their tax revenues or even manage to increase it. In addition, several countries have chosen to alter tax structures to change incentive structures for business, more than because of the threat of losing their tax base.

25. Net migration into the EU has been on the increase, rising threefold between the mid-1990s and 2003 to reach some 2 million (although a sizeable part of this is regularisation of illegal immigrants, notably in Spain). As stressed in the past, the main migratory movement is still, and is likely to remain, the immigration into the EU from neighbouring countries, Africa and, increasingly, South America (into Spain). The analysis undertaken within the framework of this study emphasises in particular that, judging from the increasing flow of remittances, links between the migrants and their families in the country of origin are probably more important than often assumed in the conceptual analysis. This would suggest that the share of migrants coming to work for a certain period in an EU country is increasing and that issues raised by this potential change of the pattern of migration should be studied carefully in addition to issue of social integration.
26. There is convincing evidence that income inequalities have been rising somewhat in many countries: Gini coefficients have risen over the two decades from the mid-1980s from levels of around 20 (indicating low inequality) in Sweden and Finland to closer to 25, and have also increased from already fairly high levels in Italy and Greece. However, there is no (or only weak) evidence that this rise in income inequalities is attributable to globalisation. In fact, recent studies and additional examination of available data suggest that the rise in income inequalities is a phenomenon intimately associated with the emergence of the 'knowledge society' and which has resulted in an increase in the return on human capital, but also, as indicated above, to a widening of the gap between those with a high and those with only a basic endowment of knowledge and skills. It is also noteworthy that over the same period, there was a significant fall to around 30 in the Gini coefficients for Ireland and Spain, showing that the movement is not all one way.
27. The inference to draw is that where there is rising inequality, it is attributable either to explicit political choices or inappropriate responses to the operation of more fundamental socio-economic drivers, such as, notably, the emergence of the knowledge society, increases in educational inequalities, or the failure of systems of education to ensure equal opportunities to all. But this process has not followed the same pattern in all countries. In the endeavour to adapt their society and to find new responses, certain countries have been more successful than others in adapting labour and product markets and, notably, in investing actively in human capital, including at the lower end of the range of endowment.
28. Examination and assessment of the evidence on the development of the level and structure of social spending suggest that social policy in general has shown a high degree of resilience in face of the challenges of globalisation and the rise in inequalities. Social protection expenditure has broadly been stable as a proportion of GDP in the EU since the early 1990s at around 27-28%, contrary to the expectation that it would be squeezed in the interests of bolstering competitiveness. Indeed, its growth over the period 1992-2003 exceeded growth in GDP for EU 15, with the implication that the European welfare state has become more, not less generous. Moreover, the evidence suggests that globalisation did not even affect the composition of social spending in OECD countries.
29. It is an open question whether an extensive social protection system should be seen as a necessary complement to a more competitive global market or an impediment to

successful participation in globalisation. Both arguments are, often overly glibly, advanced in crude terms that are at odds with the subtlety of the underlying logic. Some social protection systems, despite being costly in terms of outlays as a proportion of GDP, manifestly manage to strike a successful balance. Others are characterised by problems of inappropriate incentives and/or burgeoning costs that appear to be unsustainable.

30. Migration is a challenge for the welfare state, not least because of popular perceptions that migrants take advantage of it and give little in return. There is a high risk, in this context, of setting in motion a vicious circle in which unskilled migration inflames public opinion resulting in calls for unrealistic restrictions on migration, leading to more illegal and unskilled migration, further inflaming public opinion against migrants, forcing Governments to adopt even stricter (and unenforceable) migration restrictions.
31. Yet, overall, there is no evidence that migrants are abusing the (politically most sensitive) non-contributory parts of the welfare system, despite survey findings that suggest that 50% of EU citizens believe they do. Moreover, migration can also contribute towards the filling of gaps that may emerge for demographic reasons in the capacity of EU Member States to fund their social protection systems. This implies that migrants are of working age and are supported sufficiently in the labour market to ensure that they have high enough employment rates. In this respect, migrants have to be seen not as competitors for jobs, under-cutting indigenous workers, but as complements: the game is not zero-sum.
32. Globalisation is not – indeed by far – the only factor influencing the socio-economic and cultural fabric and is often wrongly credited with, or blamed for, much that is happening in EU Member States (and elsewhere). Longevity is increasing and the predictability of the life cycle in the sense of a stable career path is reduced for a large number of citizens. There are increasing returns on intellectual capital, that is, on investment in education and knowledge. However, this emergence of the knowledge society entails an increase in apparent income disparities and – at least in some socio-economic contexts – a change in the patterns and strength of the inclusive forces in society.

### ***Policy Issues***

33. The core policy challenge emanating from the different elements of globalisation is to enable the EU and individual Member States to take advantage of the undoubted benefits without undue social costs that might arise from ‘winners’ being expected to compensate ‘losers’. In this regard, the default position is that globalisation is much more an opportunity for added growth than a social menace.
34. To the question ‘Is a social Europe fit for globalisation?’, therefore, the answer of this report is an emphatic ‘yes’. But the benefits of globalisation cannot just be assumed to happen and, with an increased pace of change, it is inevitable that there will be losers as well as winners, with marked social consequences. The European social model is not doomed and the idea that only free market approaches are consistent with sustained prosperity are clearly wrong. Indeed, the success of the smaller open economies testifies to the scope for prospering, even with extensive and generous welfare states.
35. The principal benefits of globalisation arise from the scope it affords on the supply-side for increased specialisation, enhanced diffusion of technology, and a competitive spur to innovation and productivity growth. Consumers gain from lower prices and increased choice, while an often overlooked benefit on the demand-side is that emerging markets offer rapidly growing sales opportunities for European companies.

36. It has also to be repeated that globalisation is not a zero-sum game. Nevertheless, in assessing the benefits of globalisation and the social impact, three issues need to be taken into account. First, the gains are not uniformly distributed across individuals, regions and countries. Second, the costs of globalisation are more likely to be concentrated in the short-run, while benefits will take longer to materialise. Third, the gains will not accrue automatically, but will depend instead on success in undertaking adequate competitive, regulatory and social reforms.
37. Critics of globalisation identify a broad range of actual or potential threats from unfettered globalisation. They encompass distributive impacts, such as adverse consequences for specific groups in society, issues of cultural hegemony, concerns about environmental damage and geo-political disruption, especially now from terrorism. Threats also arise to the stability of public finances and from social tensions associated with migration.
38. Yet it is also important to stress offsetting effects. First, there is a boost to real incomes from lower prices of imports. Second, the job losses resulting from international competitive effects are small in scale compared with normal 'creative destruction' in product and labour markets. In the same vein, the pressures on social protection budgets from demographic change are much more extensive. Third, loss of low-value jobs may be less damaging than it sounds: if off-shoring means retaining only high value jobs, it could be seen as a logical answer to a declining labour force.
39. The policy challenges of globalisation can be grouped under three main headings. The first is equipping the economy to compete in the globalised age. Second, there are many demands on policy-makers to smooth adjustment. Third, there are issues of governance. One school of thought is that the EU simply has to become more like the US or other parts of the world. This standpoint can be summarised as 'work harder, innovate more and expect less'. The Lisbon strategy is, in many ways a response to globalisation, insofar as its primary aims are to reposition the EU in the global economy, but it is important to recall that the strategy also has as key goals creating employment and assuring social cohesion. As such, it is not about emulating the US model.
40. Clearly, a core policy challenge is to achieve economic flexibility with better social protection in order to create an environment capable of making the best use of the opportunities offered by globalisation. In this context, social policy has a vital role to play, not least in endowing people with capabilities, with a premium on active policies that intervene early rather than passive, reactive policies.
41. Adjusting to globalisation implies policy developments that will, in turn, have social impacts and create uncertainties that need to be managed as social risks. Labour turnover can be expected to become higher, putting a premium on the transferability and adaptability of skills, but also on suitable forms of flexibility in the workplace as well as in activating individuals. Active labour market policies are seen as part of the answer, but they are not a panacea and need to be complemented by other policies. Moreover, they are often costly and are prone to inappropriate incentives. An implication is that policy learning and experimentation are needed to find solutions that are effective, as well as attuned to conditions in the different Member States.
42. There is an important time dimension to consider, because costs such as higher unemployment and increased income inequality tend to be concentrated in the short run, while benefits in the form of lower prices, higher productivity and income will only occur later. In the same vein, many reforms will improve the benefits/costs ratio of globalisation in the long-term, yet have a short-term impact – often negative – on social cohesion that

makes them politically awkward to implement. However, in this perspective it is important that whatever measures are envisaged to counter negative social impacts should favour, not hamper, the adjustment to changing conditions. Nevertheless, leading commentators (such as Tony Atkinson) have stressed the vital role of social support in smoothing transitions. This standpoint supports the interpretation of social protection systems as productive factors.

43. It is important to recognise that in the globalised environment, migration is likely to be a permanent feature and, thus, that migration policies have to take a long-term perspective. Particular issues include whether to try to stem the increase in low-skilled migration in favour of skills tests or to impose some form of green-card (as in the US) or points system to attract specific categories of immigrants.
44. In a long-term perspective, investments in human capital should be expected to deliver not only a higher rate of growth of income and output but also a higher degree of income equality and added labour market flexibility. This is in line with, notably, the recent argumentation of Esping-Andersen in favour of shifting the emphasis in social and welfare policy towards higher priority for child care and education of the younger generations.
45. To the extent that it is the lower skilled who are most vulnerable to the effects of globalisation, there are grounds for labour market policies aimed specifically at these groups. However, it has also to be recognised that globalisation does not stand still. The most probable scenario for globalisation is that the main trends will broadly continue over the next fifteen years. Thus, it is reasonable to expect further increases in trade intensity, financial market integration and the spread of technology. Even if the growth of emerging markets slows, it will remain above that of the EU and of most Member States, such that the share of global output of the likes of China and India will expand, an implication of which is that globalisation will – as the CIA puts it – acquire a more ‘Asian’ face.
46. A significant qualitative change in globalisation can nevertheless be expected, as companies re-think their value chains and seek to reduce costs by ‘unbundling’ tasks, rather than shifting the entire production of products. The much enhanced scope for co-ordination of production afforded by ICT means that companies can more easily out-source or off-shore segments of the production process that were kept in-house in the past. Such unbundling will, make it more probable that groups of workers who have hitherto been insulated from globalisation will face new competition, but will equally give increased opportunities to the most qualified and adaptable workers in the EU.

### ***Recommendations***

47. A strong conclusion from this study is that many of the fears surrounding globalisation are greatly exaggerated and, even when justified, tend to rest on an incomplete analysis of the process. Above all, there is no empirical support for the proposition that globalisation is leading to a ‘race-to-the-bottom’ in social policy. It follows that to view globalisation as an inexorable force is, simply, unwarranted. Countries can, and do, adjust and there is no great mystery about what is needed. This message has to be repeatedly articulated and ‘sold’ to citizens.
48. Globalisation reinforces tendencies to diminish ‘local solidarity’, to pit one welfare system against another and to expose the individual to a higher degree of unpredictability and risk. Yet these processes are not inexorable, especially if a coherent, EU-wide

response is put in place. Much can be achieved by using the tools and methodology of the Open Method of Coordination to enable Member States to learn from one another and to improve their own policy performance, but it is also important for the social dimension of policy to be fully incorporated in wider policy processes, such as the 'Lisbon' Strategy for Growth and Jobs.

49. Responding to globalisation is only one rationale for 'reinventing the welfare state' and would miss a trick if it meant no more than 'compensating' those who suffer most from more intense international competition. Policy mechanisms and institutions have to be adapted to the changing economic environment, recognising that ensuing social effects are not always directly attributable to globalisation, but result from the reactions of employment and wage formation.
50. The core of a social policy response is in the following main policy domains: education and training; immigration policy; labour market reforms; and the re-shaping of social protection. There is, in addition, an international governance dimension to consider, especially in the light of the EU's commitment to international obligations as part of its Sustainable Development Strategy.
51. With regard to training and skills, these can and should be enhanced by due attention to the level of education of vulnerable target groups. It is especially important to extend adult training and learning beyond those who already have a high level of educational attainment.
52. In relation to migration there is an evident need for new more comprehensive policies to promote the social integration of different types of migrants into the economy and society of the host country. An active approach to the inclusion of immigrants should, therefore, be part of solidarity. Moreover, national migration policies are bound to have externalities for other Member States, so that establishing common principles and approaches is a pressing matter.
53. The challenge facing welfare reform is not about defending or opposing levels of social expenditure or casting doubt on specific benefits or rules. Successful welfare states respond to new paradigms and associated risks, not by cutting-back, but by reconfiguring in ways consistent with values such as those espoused by the European social model. Our fond hope is that the discourse on globalisation can be altered to reflect this analysis.

Figure 1. Schematic overview of the process of globalisation

