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Czerniak, Adam; Rapacki, Ryszard

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POLAND
COMPETITIVENESS REPORT 2016
THE ROLE OF ECONOMIC POLICY AND INSTITUTIONS

Edited by
Marzenna Anna Weresa

110 1906 2016 SGH

WORLD ECONOMY RESEARCH INSTITUTE
SGH WARSAW SCHOOL OF ECONOMICS

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Chapter 11

Key Economic Policy Developments in 2007–2015 and Challenges Ahead

Adam Czerniak, Ryszard Rapacki

This chapter seeks to assess the main thrusts of Polish economic policy from 2007 to 2015, a period when the governing coalition of the Civic Platform (PO) and the Polish People's Party (PSL) was in power, with a focus on measures designed to boost growth and streamline the country's public finances in 2010–2015.[1] After a sea change in Polish politics in the wake of the presidential and parliamentary elections in 2015, we also attempt to sum up the track record of the previous ruling coalition, which governed the country for eight years. At the same time, this chapter looks at the conditions in which the government formed by the conservative Law and Justice (PiS) party started its work, outlining the most important economic policy challenges for this new government.

Key macroeconomic policy developments

For the purposes of this analysis, the period when the PO-PSL coalition was in power can be roughly divided into three stages:

- a period of economic boom in 2007–2008, when most of the changes in economic policy[2] were the result of laws passed by a parliament dominated by PiS and its junior governing coalition partners, Samoobrona and the League of Polish Families (LPR);
- the global economic crisis period that began in the fourth quarter of 2008 and ended in early 2010;

[1] In our assessment, we focus mainly on macroeconomic policy, more specifically on the demand side of economic policy. We offered a more comprehensive assessment of supply-side economic policy (structural policy) in last year's edition of this book (Weresa 2015). The conclusions contained there continue to hold true today.

[2] These included a reduced pension premium and lower income tax rates. The latter were introduced in January 2009 and became one of the factors that caused the public sector deficit to soar in 2008–2009.

- the post-crisis period of 2010–2015, marked by strong business cycle fluctuations, significant uncertainty and numerous changes in economic policy, especially those related to public finance consolidation.

Of particular relevance to this evaluation of macroeconomic policy pursued in 2007–2015 are government efforts to reduce the general government deficit in the post-crisis period. During the global downturn the deficit increased to 7.5% of GDP in 2009, from 1.9% in 2007, according to ESA95 accounting standards (Eurostat 2014). As a result, after Poland exceeded the 3% of GDP deficit threshold imposed by the EU Stability and Growth Pact (SGP), the European Commission in May 2009 launched its Excessive Deficit Procedure (EDP) and demanded that the Polish government reduce persistent public finance imbalances (Council of the European Union, 2009).

The government imposed an austerity policy on both the revenue and expenditure side of the Polish budget. The most important measures aimed at boosting public revenues were:

- an increase in the VAT rates from January 2010 to December 2016 (the main rate rose from 22% to 23%);
- an increase in disability pension contributions by 2 p.p. to 8% as of February 2012;
- several increases in excise taxes on tobacco products and alcoholic beverages;
- freezing income tax brackets at their 2008 levels;
- implementing several anti-tax evasion laws, including one to prevent fraud in VAT payments by companies trading in goods such as steel rods, fuel, and precious metals, and one imposing taxes on companies registered in tax havens such as Cyprus, Malta, and Luxembourg and thus evading corporate income taxes;
- adopting a law increasing the tax on undisclosed income and
- adopting regulations launching a national "receipt lottery" in a bid to boost the country's VAT revenues.

Most of the savings made by the government in the post-crisis period focused on the expenditure side of fiscal policy (4.1 percentage points of GDP, compared with 0.1 p.p. of GDP on the revenue side in 2010–2014 (Rada Ministrów, 2015)). The most important measures concerned the pension system. These included a reduction in the size of the Private Pension Funds and an increase in the retirement age. The first modifications focused on the mechanism for transferring pension contributions. In 2011, the government temporarily reduced the amount of pension premiums transferred from the Social Insurance Institution (ZUS) to Private Pension Funds (OFE) from 7.3% to 2.3% (with a subsequent increase to 2.8% in 2013). The key change in the system, however, took effect in early February 2014, when 51.5% of OFE assets were transferred to ZUS. The transferred T-bonds were redeemed and public debt fell by 9 p.p.

to 49.5% of GDP at the end of the first quarter of 2014, according to ESA'95 methodology (Eurostat, 2014).

The key change in the fully funded pillar was in the amount of funds that will be transferred from ZUS to OFE in subsequent years. Prior to 2011, the entire pension contribution of 7.3% was transferred to OFE. Under the new rules, it will now stay in ZUS and be recorded on a special sub-account indexed against nominal GDP growth. Those who wished to continue saving in the fully funded pillar were given an alternative option. They could declare that they wanted the state to transfer 2.98% of their contributions to private pension funds. Such a decision was made by 2.5 million Poles, or 15.1% of all those who were eligible. This is probably not enough to keep in positive territory private pension fund net inflows (paid-in contributions minus the transfer of assets to pensioners). In January 2015, a year after the reform, ZUS transferred PLN 184.5 million to private pension funds from premiums, and OFEs transferred to ZUS PLN 346 million[3] worth of assets for the payment of benefits to people approaching retirement. After the introduction of the new law, government expenditure in 2015 was PLN 18.6 billion (1 percent of GDP) lower than in the no-change-in-economic-policy scenario. This was due to a lower Social Security Fund deficit combined with lower debt-servicing costs (Ministry of Labor, 2014).

Another important change in the pension system was a decision in 2012 to increase the retirement age to 67 for both men and women. Previously, men retired at 65 and women at 60. The retirement age is set to increase gradually. Beginning January 2013, the retirement age will be increasing at a rate of three months per month. The target level will be reached in 2020 for men and in 2040 for women. In all, the government saved around PLN 6 billion as a result of this from 2012 to 2015 (MPiPS, 2012).

In order to reduce the nominal and structural deficit, the PO-PSL government decided to go ahead with institutional changes. Since 2010, the parliament has passed a number of new expenditure rules aimed at limiting the growth of public spending at both the central and local government levels. The most important of these was the so-called stabilizing expenditure rule, which was introduced in 2014 to replace the ineffective disciplinary rule. This new rule was based on a complex mathematical formula for the upper ceiling on planned public spending enshrined in subsequent budgets. The limit depends on historical and projected real GDP growth, the CPI[4] inflation forecast, and on the public deficit and debt levels. The rule takes into account

[3] According to ZUS and OFE press release data.

[4] In December 2015, the inflation forecast was replaced by the NBP's inflation target (2.5%). The change stemmed from a number of forecasting errors that led to cuts in public spending, as well as a need to raise the ceiling for government expenditure in 2016.

discretionary policy changes to the income side of the budget.[5] It covers nearly 90% of general government expenditures and was first applied to the 2015 draft budget.

The introduction of the stabilizing fiscal rule changed the process of drafting the budget. Previously, the budgets of the central and local governments and other public institutions were drafted independently. Under the new rule, the Ministry of Finance must be informed by all institutions covered by the new regulations about expenditures planned for the subsequent year. Taking this into account, the ministry adjusts central budget spending in order to keep public spending below the limit. This increases central administration control over fiscal policies pursued by the public sector as a whole.

To reduce the budget deficit, the Ministry of Finance introduced another important institutional change: central liquidity management in the public sector. Some public institutions, including the national healthcare fund (NFZ), special-purpose funds, and the State Forest authority, were forced to keep their surplus funds on a Ministry of Finance account in the publicly owned BGK bank. In this way, other institutions could use surplus liquidity in the sector to finance their short-term deficits instead of issuing bonds or borrowing money from private banks. Thanks to this management system, general government debt-service costs were reduced by several hundred million zlotys a year and the borrowing needs were lowered by a total of PLN 33 billion (2% of GDP) in 2010–2014. Another important measure aimed at reducing the budget deficit was a decision to freeze compensation expenditures in the public sector at their 2009 nominal level. This move yielded PLN 2.2 billion in savings in 2014 alone (Ministry of Finance, 2014).

As a result of these measures, the government managed to permanently reduce the general government deficit from 7.6% of GDP in 2010 to 3.2% in 2014. Thanks to this, the European Commission dropped the excessive deficit procedure against Poland in June 2015 (Council of the European Union, 2015). The introduction of long-term austerity measures (including the pension system reform, the establishment of the stabilizing expenditure rule, and the centralization of liquidity management) brought down the structural deficit to 2.9% of GDP in 2014, from 6.0% in 2011 (European Commission, 2014).

Because of the need to cut public spending in the post-crisis period, the room for active labor market policies by the government was limited and focused mostly on activities that did not pose additional burdens on the public finance sector. One of the most important government programs designed to support economic development, and one that has produced tangible economic results, was the so-called de minimis

[5] As of December 2015, the rule also includes one-off and temporary changes in government revenue, such as proceeds from the sale of a license for the use of broadband LTE internet frequencies.

guarantee program. Introduced in March 2013, this program was based on BGK bank guarantees granted to secure up to 60 percent of the amount of business and investment loans[6] incurred by companies with less than 250 employees in commercial banks. A total of 100,100 companies benefited from the program from 2013 to 2015, and the value of BGK guarantees reached PLN 25.6 billion for loans totaling PLN 45.5 billion. The results of a study conducted by BGK (Kowalczyk, Kaczor, 2015) show that during the first three years, these guarantees helped increase lending to companies by PLN 12.3 billion, which accounted for a third of the total increase in the value of loans to companies under the program (PLN 35.8 billion). As a result, companies increased employment by around 54,000.

In its policy regarding the labor market, the government took action to increase the efficiency of spending by labor offices. To this end, for the first time in the history of the Polish public sector, a conditional subsidy was introduced. As of May 2014, the amount of money transferred to labor offices for salaries depends on how successful they are in reducing the unemployment rate. Seventy percent of the subsidy is disbursed as previously, but the remaining 30% goes only to the most efficient labor offices. Furthermore, under the new regulations, unemployed citizens registered in labor offices are now classified into three categories depending on the skills of the unemployed person and when they were registered at the labor office. Each group will be subject to different conditions and entitled to different privileges.

The government pursued an active housing policy in the analyzed period. From 2007 to 2012, a subsidy program financed by BGK and called "Family on its Own" was at work to help first-time buyers purchase a home. More than half of the 192,000 households that used funds under the program acquired an apartment on the resale market, mostly in the first three years (BGK, 2013). In 2010–2012, the program helped prevent a sudden drop in demand for new housing in the wake of increased unemployment and tighter lending policies by banks. Transaction prices on the new-home market in major cities fell by only 14% between the first quarter of 2010 and the fourth quarter of 2012 (Łaszek et al., 2014). This was accompanied by a reversal of proportions among those benefitting from the “Family on its Own” program. The proportion of households that used program funds to buy new homes grew from 9.6% in 2007 to 39.8% in 2013.

After the “Family on its Own” program ended, the government began working on another housing subsidy program for young families to make new housing more affordable and help revive the country’s stagnant real estate market. A new stimulus

[6] BGK began offering guarantees on investment and development loans after the program was expanded in November 2013.

program, "Housing for the Young," came into force at the beginning of 2014, allowing first-time buyers to partially finance their down payments and pay their loan installments. This program initially covered all types of new residential premises. Beginning Sept. 1, 2015, it was expanded to include residential premises offered on the resale market and by housing cooperatives. In addition, support for large families was increased. The program led to a gradual reduction in surplus housing unsold by developers and to a steady increase in transaction prices (by 2% in the first three quarters of 2014 on average).

In 2014, the government also launched a third program to stimulate the supply of housing, called "Apartments for Rent." That same year the government also started work to support building societies (TBS) with BGK loans. Both of these programs began to produce results in mid-2015, but a detailed assessment of their impact on the housing market cannot be made until the end of 2016.

Other flagship PO-PSL government programs to support economic development, including an initiative called Polish Investment for Development, designed to co-finance investment growth through public-private partnerships, produced no tangible economic results.

Key challenges

In this section, we outline the "opening balance" of the new Law and Justice government and list the biggest challenges facing Polish economic policy makers in the years ahead. We focus on two categories of development barriers and threats to the Polish economy: (i) threats that have been growing for many years, including those resulting from the negligence and failures of the PO-PSL coalition (as well as a number of previous governments), and (ii) new challenges that are a direct consequence of the first 100 days of the PiS government.

Major economic policy challenges in Poland can be classified into two interconnected categories. The first category deals with conceptual, political and institutional development barriers that make up a broad framework of economic activity in Poland and determine the structure and strength of incentives influencing the behavior and decisions of economic agents. The second category covers challenges that stem from the mode of operation of the Polish economy, its growth factors and macroeconomic performance.

Conceptual, political and institutional challenges

In the first category, the most fundamental weaknesses of Polish economic policy include the failure of successive governments and policy makers to define the target point on Poland's road from "plan to market" – the model of capitalism that should be built in the country. The goal of systemic transformation in Poland used to be defined vaguely – explicitly or implicitly – as the creation of a liberal market economy (or capitalism), without a clear vision of what shape it should take.

Meanwhile, the European Union is home to at least four models – or varieties – of capitalism with diverse institutional architectures and market infrastructures. A study by Hanson (Hanson 2006) finds that the European Union's body of law, acquis communautaire, gives member countries a surprisingly wide margin of freedom in designing and implementing their own national institutions and solutions that best fit their specific needs.

Due to the lack of a clear vision about the model of capitalism that would best fit the country's development determinants and aspirations, Poland's emerging market economy is largely a hybrid. Various parts of the country's institutional architecture come from different institutional orders and are not complementary. As a consequence, instead of triggering positive synergies and increased efficiency, this institutional ambiguity has generated rising frictions and increased idle capacity in the system.

Second, the government has apparently failed in its attempts to precisely define Poland's present and future role in the EU – other than just being a recipient of EU funds. While the need for efficient absorption of EU funds (and institutions) goes without saying, an optimal allocation and choice of alternative uses for these funds should originate from a national development strategy (an outline of which, known as the Morawiecki Plan, appeared only recently). While Poland has done relatively well in terms of gaining access to EU funds, it has performed much worse in defining its development priorities in the allocation and use of these funds. At the same time, it has underperformed in its endeavors to fully recognize the costs and benefits of various EU programs in terms of Poland's national interest.

Third, Poland risks becoming a peripheral EU member country in this context. Under this scenario, Poland would increasingly specialize in the production of simple manufacturing goods with a low level of processing and relatively low value added, being at best a subcontractor for more technologically advanced products.

Fourth, apart from fundamental weaknesses, the list of major challenges includes a failure by government to create favorable conditions for sustainable, long-term economic growth, in particular failure to generate positive externalities for the private business sector. Specifically, key government failures in this area include underfunding

of R&D activities, insufficient or unavailable support for the development and upgrading of human capital, neglecting the significance of social capital – whose insufficient stock ranks among the most acute development barriers in the Polish economy – and ineffective efforts to foster the development of information and communication technologies (ICT).

This government weakness stems mainly from a strong redistributive bias in Poland's public expenditure policy (a distorted pattern of government functions) at the expense of development spending. Other causes include a failure to meet the "golden rule" of public finance, the continually growing scale of rent-seeking, and the persistence of an unproductive model of entrepreneurship, as described by American economist William Baumol (Baumol 1990).

Moreover, Poland continues to exhibit many symptoms of the Myrdalian "soft state" pattern where the incidence of corruption still tends to be excessive, the judiciary branch of power is increasingly inefficient (in particular business courts), and law enforcement continues to be weak, which means a strong asymmetry between formal and informal institutions in favor of the latter (Rapacki 2012). At the same time, there have been mounting symptoms of a declining quality of public and merit goods such as healthcare and education.

Finally, in contrast to some other transition countries in the region (Slovakia and the Baltic states), Poland has not managed to substantially downsize its government sector and reduce the scope of its functions during the past eight years (and more generally throughout the transition period). If the proportion of public expenditure to GDP is adopted as the basic gauge of the size of government, this index has remained stable in Poland since the early 1990 s, at above 40%. In the global perspective, the index for Poland has been about twice as high as those in peer countries with a similar level of economic development (23%–24%). At the same time, the figure has remained close to the average level in the European Union and the OECD. This pattern implies that Poland displays indicators comparable to those in the most developed EU countries. In other words, the size of government in Poland is excessive for the country's economic development level. What's more, in the last three to four years the size of government in Poland has begun to grow again. Employment in public administration has increased by over 10% to more than 600,000.

Macroeconomic challenges

Polish economic policy faces a number of major macroeconomic development challenges. These include the following:

The first challenge that is likely to adversely affect Poland's development prospects in the next 30 to 45 years is its unfavorable demographic trends. These include a shrinking population, unfavorable changes in the age composition of Polish society, emigration and brain drain, and a permanent decline in the dependency ratio – the number of those working per one retired person.

The second challenge is that the Polish labor market is not particularly efficient; as a result, the level of economic activity in Poland ranks among the lowest in the European Union. At the same time, the youth unemployment rate and the share of flexible forms of employment are among the highest in the EU (Rapacki 2016).

Third, the Polish economy displays the lowest propensity to save and the lowest investment-to-GDP ratio in Central and Eastern Europe. Under the endogenous growth model, a sufficiently high investment rate and adequate domestic savings – which provide funding for investment in the long term – are the necessary conditions for fast and sustainable economic growth.

A fourth key barrier is a persistently low innovative capability of the Polish economy. Of special note among its numerous symptoms is a low proportion of high-tech products in manufacturing exports (7%) and a huge license trade deficit (the ratio of export receipts to import spending is 1:10).

A fifth major challenge for Polish economic policy is a low (and shrinking, according to some empirical studies) stock of social capital. Using the terminology devised by Francis Fukuyama, Poland should be described as a low-trust society (Fukuyama 1997). Moreover, while Poles' distrust of government has strong historical roots, a new trend has emerged suggesting a similar distrust on the part of the state toward citizens and private business. As a result, the government and public administration in Poland tend to devise bureaucratic hurdles, which, combined with increased government intervention, limit economic freedom.

A sixth serious development challenge stems from rapidly growing tensions in Poland's energy mix, which are mostly due to delayed investment projects aimed at developing and modernizing the country's power-generation base. The effect of this factor is compounded by the prospect of a substantial rise in the costs of generating and supplying electricity in Poland, in the wake of an intergovernmental agreement (known as the climate package) adopted by the EU in the autumn of 2014. The package calls for considerable reductions in toxic emissions and the resulting need to switch to more environment-friendly energy generation technologies.

Overall, the cumulative effect of these development barriers, combined with a missing or insufficient response of economic policy, may eventually lead to a steady deceleration of growth dynamics and a subsequent deterioration in the international competitiveness of the Polish economy. Some symptoms of this new unfavorable trend

have already appeared in Poland. In the past few years the Polish economy has decelerated in terms of potential GDP growth, from more than 5% to around 3% per annum, i.e. by about 2.5 percentage points. What's more, based on long-term forecasts by the European Commission, the OECD and our own projections (Matkowski, Próchniak, Rapacki 2013 and 2014),[7] after 2020 Poland's economic growth is likely to decelerate further – to a level below 2% annually. This may lead to a persistently high unemployment rate, in the range of 6.5%–7.5%.

Even worse, there are reasons to believe that such a scenario is likely to produce one more serious long-term threat: it may perpetuate an imitative model of development under which Poland would become an importer of ready-made institutions, even though some of these would be incompatible with the country's priorities and development potential.

New challenges

In this section, we attempt to outline key economic policy challenges resulting from recent moves by the Law and Justice (PiS) government during its first 100 days in power. We assume that PiS will try to deliver on its election promises, which would lead to the high probability of an expansionary fiscal policy, and – to a lesser extent – expansionary monetary policy. We also believe it is likely that the government will press ahead with the kind of institutional changes it launched in November 2015 in a bid to change the foundations of Poland's political system and liberal democracy. This could negatively affect Poland's image abroad and weaken its position in the European Union. This scenario, if it materializes, will mean the emergence of new economic policy challenges in the form of a variety of threats to short-, medium-, and long-term development.

Short-term effects

- Strong fiscal expansion, resulting mainly from increased government expenditure on allowances for large families (the so-called 500+ program with a total price tag of anywhere from PLN 15 billion to PLN 18 billion in 2016 and PLN 20 billion to PLN 25 million in 2017) and a more than 100% increase in the free-tax threshold for personal income (leading to a decrease in tax revenues by anywhere from

[7] The newest simulative forecast for the development trajectory of the Polish economy and the process of income convergence in relation to the EU15 can be found in chapter 2 of this report.

PLN 12 billion to PLN 16 billion and the corresponding rise in disposable income). Meeting all election promises in the area of social transfers would pose an additional burden on the budget to the tune of around PLN 50 billion a year.

- A likely increase in the 2017 budget deficit to above 3% of GDP, thus exceeding the Maastricht nominal convergence criterion. According to the latest forecast by the European Commission, Poland's general government deficit in 2017 could reach 3.4%, with the prospect of a further rise in 2018 and 2019.
- As a result, the European Commission may reopen its excessive deficit procedure with regard to Poland.
- Increased government spending (mostly on consumption) financed from a growing deficit and public debt would lead to a crowding-out effect in the economy with regard to private investment, which would consequently change the way in which national income is distributed (on the demand side); the role of the private sector would fall in favor of the public sector.
- At the same time, due to increased "rigid" government expenditure, not accompanied by a parallel increase in permanent sources of funding, the structural deficit might increase.
- A growing general government deficit, which is equivalent to increased negative government savings, would reduce the possibility of financing investment projects from domestic private-sector savings.
- An increased perceived risk of investing in Poland would translate into a higher cost of borrowing on international financial markets. Such a scenario is increasingly probable after a January 2016 decision by rating agency Standard and Poor's to downgrade Poland's investment rating.
- Possible temporary acceleration in economic growth on the demand side, as a result of increased government and household spending.
- This effect may be somewhat strengthened if the government goes ahead with its announced policies to encourage the development of small and medium-sized enterprises (SMEs) through the launch of a system of cheap loans subsidized by the government (more expansionary monetary policy). The probability of such a scenario increases with recent changes in the lineup of the Monetary Policy Council (RPP) and a planned change of central bank governor in June 2016. However, due to structural and supply-side barriers existing in the Polish economy, which are highlighted in the next section, the pro-growth effects of these measures may prove to be short-lived and much smaller than the government expects.
- High probability of a complete dismantling of the three-pillar pension system accompanied by the takeover by the government of the remaining part of pension assets accumulated in OFE pension funds.

- A reversal of the previous government's pension system reform (based on raising the retirement age from 60 to 65 years for women and from 65 to 67 years for men) would create additional constraint for the current and future liquidity of the Social Insurance Fund and the national budget.

Medium- and long-term effects

- Increased inflationary pressure and expectations resulting from two interrelated factors: (1) a significant loosening of fiscal and monetary policies, and (2) almost full use of the production capacity in the Polish economy (with the output gap estimated at only –0.6% of potential GDP) and a significant deceleration in the rate of potential economic growth (to no more than 3.0% a year).
- This may mean that additional incentives for growth from fiscal and/or monetary expansion (in the form of measures such as increased lending to SMEs) may lead to an overheating of the Polish economy and accelerated inflation rather than accelerated GDP growth.
- In the slightly longer term, insufficient propensity to save (currently standing at 18%–19% of GDP) and a low investment rate (20% instead of at least 24–25% of GDP) may contribute to a slowdown in the Polish economy.
- The crowding-out effect (see above) may have a similar effect. It will lead to a less efficient use of resources in Poland on average (a decrease in TFP) and thus a deceleration of potential economic growth.
- In this context, it is also worth highlighting a contradiction between the actual moves of the governing party and the main objectives announced by Deputy Prime Minister Mateusz Morawiecki in mid-February 2016. Morawiecki's Plan for Responsible Development calls for a significant increase in domestic savings and investment, coupled with increased national innovative capability and support for domestic capital. However, according to standard economic theory, it is impossible to increase the consumption and investment rates while limiting the role of foreign savings in an economy.
- A takeover by the government of the remaining OFE assets would result in a conversion (postponement) of the official, "visible" part of the public debt into hidden, "invisible" debt (promises of future pension payments) and a significant increase in the latter form of debt.
- A possible decision by the government (parliament) to backtrack on the pension reform based on extending the retirement age would decrease the supply of labor and lead to a drastic reduction in the replacement rate for future retirees. At the

same time, it could threaten the long-term solvency of the Social Insurance Institution and the public sector.

- Such a decision could also deal a further body blow to the Warsaw Stock Exchange, which has already underperformed significantly in the wake of the 2014 nationalization of half of the OFE pension funds' assets by the PO-PSL government.

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