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FISCAL RULES AND GREEN GROWTH IN EUROPE

Dimitra Mitsi

Ministry of Finance
15 Diotimas Street, Tripolis Arcadias, Greece

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ABSTRACT

This paper explores the interplay between fiscal rules in Europe and the pursuit of green growth objectives. With the pressing need to address climate change and promote sustainable development, countries worldwide are increasingly focusing on integrating environmental considerations into their economic policies. In Europe, where fiscal rules have traditionally been a cornerstone of economic governance, the challenge lies in aligning these rules with the imperatives of environmental sustainability. This paper examines the existing fiscal frameworks in Europe, assesses their compatibility with green growth objectives, and discusses potential avenues for enhancing coherence between fiscal rules and environmental priorities.

KEYWORDS: fiscal rules and green growth.

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1. INTRODUCTION

In recent decades, the European Union (EU) has been at the forefront of efforts to establish robust fiscal rules aimed at ensuring economic stability and fiscal discipline among its member states. Concurrently, the imperative of addressing environmental challenges, particularly climate change, has gained increasing prominence on the global agenda. As the urgency to transition towards a more sustainable and resilient economy intensifies, the intersection between fiscal rules and green growth objectives becomes increasingly pertinent.

Fiscal rules, such as those enshrined in the Stability and Growth Pact (SGP), have long served as cornerstones of European economic governance, aiming to promote fiscal responsibility and prevent excessive deficits and debt accumulation. However, the traditional focus of these rules on short-term fiscal targets and debt reduction has sometimes led to tensions with broader environmental sustainability goals. The pursuit of green growth, characterized by environmentally

sustainable and socially inclusive economic development, necessitates a reevaluation of fiscal policies to ensure coherence and alignment with environmental imperatives.

This paper seeks to explore the intricate relationship between fiscal rules in Europe and the pursuit of green growth objectives. It begins by examining the existing fiscal frameworks in Europe, including the SGP and national fiscal rules, highlighting their objectives, design, and enforcement mechanisms. Subsequently, it delves into the concept of green growth, emphasizing its significance in addressing environmental challenges while fostering economic prosperity.

Central to the discussion is an assessment of the compatibility between existing fiscal rules and green growth imperatives. While fiscal discipline remains essential for economic stability, the paper explores potential conflicts or synergies between fiscal rules and environmental sustainability objectives. It also identifies challenges associated with integrating green growth considerations into fiscal frameworks, such as the need for coherent policy coordination and accounting for long-term environmental costs and benefits.

Moreover, the paper discusses opportunities for leveraging fiscal rules to advance environmental objectives, including the integration of environmental criteria into fiscal policymaking and budgetary processes. Drawing on insights from select European countries' experiences, it provides case studies to illustrate policy initiatives, successes, and challenges encountered in reconciling fiscal constraints with green growth strategies.

In conclusion, the paper underscores the importance of aligning fiscal policies with environmental imperatives to achieve sustainable and inclusive economic development in Europe. By offering policy recommendations and identifying future directions for research and innovation, it aims to contribute to the ongoing discourse on fiscal sustainability and environmental stewardship in the region.

2. LITERATURE REVIEW

The literature on the interaction between fiscal rules and green growth in Europe reveals a complex and dynamic relationship characterized by tensions, synergies, and policy dilemmas. A comprehensive analysis of this literature highlights several key insights and themes.

Scholars consistently highlight tensions between fiscal rules, which prioritize short-term fiscal targets and debt reduction, and long-term environmental objectives, such as climate mitigation and biodiversity conservation. The rigid enforcement of fiscal rules may constrain investments in green infrastructure and sustainable development initiatives (Eyraud & Weber, 2020). Despite tensions, there is recognition of potential synergies and co-benefits between fiscal discipline and green growth. Some studies argue that investments in green technologies and environmental protection can stimulate economic growth, create jobs, and enhance competitiveness, thereby contributing to fiscal sustainability in the long run (OECD, 2020).

A recurring theme in the literature is the need to integrate environmental criteria into fiscal frameworks to ensure coherence between fiscal policies and environmental priorities. Suggestions

include incorporating carbon pricing mechanisms, emissions targets, and environmental impact assessments into fiscal rules to incentivize sustainable practices (Hagemann & Poots, 2018). Scholars emphasize the importance of policy instruments and initiatives aimed at promoting green growth, such as carbon pricing, renewable energy subsidies, and eco-innovation programs. These policies can provide incentives for businesses to adopt sustainable practices and stimulate investments in clean technologies (Acemoglu et al., 2016).

Case studies of European countries provide valuable insights into the challenges and opportunities associated with integrating fiscal rules and green growth strategies. These studies examine the effectiveness of policy initiatives, institutional arrangements, and regulatory frameworks in facilitating the transition to a low-carbon, resource-efficient economy (Hepburn et al., 2021). Policy analyses and recommendations emphasize the need for reforms in fiscal governance to better accommodate environmental priorities. Flexibility within fiscal rules, support for innovation and technology transfer, and international cooperation are identified as crucial elements for advancing green growth agendas while ensuring fiscal sustainability (IMF, 2020; European Commission, 2021).

Studies often delve into the institutional dynamics and governance challenges associated with integrating fiscal rules and green growth objectives. These include issues of policy coordination among different levels of government, the role of supranational institutions such as the European Commission in guiding environmental policies, and the need for transparent and participatory decision-making processes (Barrett & Fankhauser, 2019). Scholars emphasize the importance of considering distributional impacts and social equity considerations in the design and implementation of fiscal rules and green growth policies. Environmental policies, such as carbon pricing or energy subsidies, may have differential effects on households and industries, highlighting the need for targeted measures to mitigate potential inequities (Sutherland & Price, 2019).

Some studies draw on insights from behavioral economics to analyze the effectiveness of policy instruments and interventions aimed at promoting green growth. Understanding individual and organizational behavior can provide valuable insights into the design of incentives, nudges, and information campaigns to encourage sustainable practices and investment decisions (Thaler & Sunstein, 2008). The literature underscores the importance of long-term planning and resilience building in the face of environmental uncertainties and systemic risks. Fiscal rules and green growth strategies should incorporate considerations of climate adaptation, disaster preparedness, and ecosystem restoration to enhance societal resilience and reduce vulnerability to environmental shocks (IPCC, 2021).

Given the transboundary nature of environmental challenges, scholars highlight the significance of international cooperation and policy spillovers in shaping fiscal and environmental outcomes. Coordinated action at the regional and global levels is essential for addressing cross-border environmental externalities, promoting technology transfer, and mobilizing financial resources for sustainable development (UNEP, 2021). Research often focuses on developing evaluation frameworks and performance metrics to assess the effectiveness and impact of fiscal rules and green growth policies. Indicators such as carbon intensity, resource efficiency, and social inclusion

are used to measure progress towards sustainability goals and inform policy adjustments and recalibration (European Environment Agency, 2020).

In synthesizing these insights, the literature offers a nuanced understanding of the multifaceted relationship between fiscal rules and green growth in Europe. By addressing governance challenges, distributional concerns, behavioral dynamics, and international dimensions, policymakers can develop holistic strategies that promote sustainable and inclusive development while ensuring fiscal stability and resilience.

3. IMPACT OF FISCAL RULES ON ENVIRONMENTAL CHALLENGES

The impact of fiscal rules on environmental challenges can be profound and multifaceted, influencing various aspects of environmental policy, resource management, and sustainability efforts.

First of all, fiscal rules dictate government spending priorities and budget allocations. When fiscal rules prioritize short-term fiscal targets or deficit reduction, environmental programs and initiatives may receive lower funding priority. This can result in underinvestment in critical areas such as pollution control, conservation efforts, and renewable energy development, exacerbating environmental challenges. Fiscal rules influence taxation policies, including taxes on environmental pollutants, carbon emissions, and natural resource extraction. Effective environmental taxation can incentivize sustainable practices and internalize the external costs of pollution and resource depletion. However, fiscal rules may constrain the implementation of environmental taxes if they prioritize revenue generation or prohibit tax increases.

Fiscal rules shape incentives for private sector investments in environmental sustainability. Subsidies, tax breaks, and incentives provided to industries may either promote or discourage environmentally friendly practices. For example, subsidies for fossil fuel industries can perpetuate reliance on polluting energy sources, while incentives for renewable energy can stimulate investments in clean technologies.

Fiscal rules influence infrastructure development decisions, including investments in transportation, energy, and waste management infrastructure. Infrastructure projects funded under fiscal constraints may prioritize cost efficiency over environmental considerations, leading to the construction of environmentally harmful infrastructure or inadequate investments in sustainable alternatives.

Fiscal rules can impact the capacity of governments to enforce environmental regulations and ensure compliance with environmental standards. Budgetary constraints imposed by fiscal rules may limit funding for environmental agencies, monitoring programs, and enforcement activities, weakening regulatory oversight and enforcement efforts.

Fiscal rules affect government funding for research, innovation, and technology development, which are essential for addressing environmental challenges. Budgetary constraints may constrain

investments in green innovation and research initiatives, limiting progress towards developing sustainable technologies and solutions to environmental problems.

Fiscal rules often prioritize short-term fiscal targets, which may undermine long-term planning and investment in environmental sustainability. Environmental challenges such as climate change require long-term, strategic investments in mitigation and adaptation measures. However, fiscal rules that emphasize immediate fiscal stability may discourage investments with long-term environmental benefits.

Overall, the impact of fiscal rules on environmental challenges depends on the specific design and implementation of fiscal policies, as well as the broader socio-economic context. While fiscal rules can pose constraints on environmental action, there are opportunities to align fiscal policies with environmental objectives through policy reforms, innovative financing mechanisms, and integrated planning approaches.

4. Challenges in Aligning Fiscal Rules with Environmental Objectives

Aligning fiscal rules with environmental objectives presents several challenges due to the inherent tension between short-term fiscal goals and long-term environmental sustainability.

Fiscal rules often prioritize short-term fiscal targets such as deficit reduction and debt stabilization. These targets may conflict with the long-term nature of environmental challenges, which require sustained investments and policy commitments over extended periods. The short-term focus of fiscal rules can lead to underinvestment in environmental initiatives that yield benefits over the long term.

Achieving coherence between fiscal rules and environmental objectives requires integration across government departments and policy domains. However, government structures may be fragmented, with different ministries responsible for fiscal policy and environmental management. Siloed decision-making processes and conflicting policy priorities can hinder efforts to align fiscal rules with environmental goals.

Fiscal rules impose constraints on government spending and borrowing, limiting the fiscal space available for environmental investments and initiatives. Meeting fiscal targets may require austerity measures, including spending cuts and revenue increases, which can result in reduced funding for environmental programs and services. Budgetary constraints may also discourage governments from pursuing ambitious environmental policies that require significant financial resources.

The alignment of fiscal rules with environmental objectives may face resistance from vested interests and powerful stakeholders. Industries that benefit from environmentally harmful practices, such as fossil fuel extraction or intensive agriculture, may oppose measures that impose additional costs or regulatory burdens. Political considerations, including electoral cycles and public opinion, can also influence decision-making on fiscal and environmental policies.

Fiscal rules and environmental challenges are characterized by complexity and uncertainty, making it difficult to design and implement effective policy solutions. Environmental issues such as climate

change involve interconnected systems and long-term dynamics that are challenging to model and predict. Fiscal rules that lack flexibility or fail to account for environmental risks may be ill-equipped to address emerging challenges or respond to changing circumstances.

Fiscal rules may lack specific policy instruments or tools to directly address environmental objectives. While taxation policies and budget allocations can influence environmental outcomes, fiscal rules may not explicitly prioritize environmental considerations or provide mechanisms for monitoring and evaluating environmental performance. Integrating environmental criteria into fiscal frameworks requires the development of new policy instruments and indicators to track progress towards sustainability goals.

Achieving alignment between fiscal rules and environmental objectives requires coordination and cooperation among governments, international organizations, and other stakeholders. Environmental challenges are often transboundary in nature, requiring collective action and cooperation across borders. Fiscal rules that operate at the national level may need to be harmonized or coordinated with international agreements and initiatives to address global environmental issues effectively.

Addressing these challenges requires innovative approaches and policy reforms to reconcile fiscal discipline with environmental sustainability. This may involve integrating environmental considerations into fiscal frameworks, promoting green finance and investment, and fostering collaboration across sectors and levels of governance. By overcoming these challenges, governments can advance holistic strategies that promote both fiscal stability and environmental stewardship.

5. Strategies for Aligning Fiscal Policies with Environmental Objectives

Aligning fiscal policies with environmental objectives requires a comprehensive approach that integrates environmental considerations into budgetary processes, taxation policies, and government spending decisions. Implement green budgeting frameworks that incorporate environmental considerations into budgetary processes. Conduct environmental impact assessments of fiscal policies and expenditures to evaluate their potential environmental impacts and ensure that environmental costs and benefits are adequately accounted for in decision-making.

Reform taxation policies to internalize environmental externalities and incentivize sustainable behavior. Introduce taxes or levies on carbon emissions, pollution, and natural resource extraction to discourage environmentally harmful activities and generate revenue for environmental investments. Use market-based instruments such as emissions trading schemes to allocate pollution rights efficiently.

Reform subsidies and incentives to promote environmentally sustainable practices and industries. Redirect subsidies away from fossil fuels and other environmentally harmful activities towards renewable energy, energy efficiency, and sustainable agriculture. Provide financial incentives and support mechanisms for green innovation, research, and development.

Utilize public procurement policies to promote environmentally friendly products and services. Establish green procurement criteria that prioritize products with lower environmental impacts, such as energy-efficient appliances, sustainable construction materials, and eco-friendly transportation options. Encourage government agencies to procure goods and services from suppliers that adhere to environmental standards and practices.

Allocate resources towards investments in green infrastructure and technologies that support environmental objectives. Prioritize funding for projects that enhance energy efficiency, promote renewable energy deployment, improve waste management systems, and protect natural ecosystems. Invest in sustainable transportation networks, renewable energy grids, and climate-resilient infrastructure to build a low-carbon and resilient economy.

Provide fiscal flexibility within budgetary frameworks to accommodate investments in environmental sustainability. Allow for adjustments to fiscal rules or targets to account for investments in green infrastructure and climate adaptation measures. Adopt long-term planning horizons and sustainability frameworks that prioritize intergenerational equity and environmental stewardship.

Engage the public and stakeholders in the formulation and implementation of environmental fiscal policies. Raise awareness about the linkages between fiscal policies, environmental sustainability, and public welfare. Foster public participation in decision-making processes through consultations, citizen engagement mechanisms, and transparency measures.

Collaborate with international partners and organizations to address transboundary environmental challenges and promote global sustainability goals. Align fiscal policies with international agreements and commitments on climate change, biodiversity conservation, and sustainable development. Share best practices, exchange knowledge, and mobilize resources for joint initiatives that advance environmental objectives on a regional and global scale.

By adopting these strategies, governments can integrate environmental considerations into fiscal policies and advance sustainable development agendas that promote both economic prosperity and environmental stewardship. A holistic approach to fiscal policymaking that prioritizes environmental sustainability can contribute to building a resilient and inclusive economy for present and future generations.

6. CASE STUDIES

Germany's Renewable Energy Transition (Energiewende)

- Germany's Energiewende is a comprehensive strategy aimed at transitioning the country's energy system towards renewable sources and reducing greenhouse gas emissions. Fiscal policies play a crucial role in incentivizing renewable energy deployment and promoting energy efficiency.
- Case Study Highlights:
 - Feed-in Tariff (FIT) Program: Germany implemented a feed-in tariff program that guaranteed fixed, above-market prices for renewable energy producers, providing a strong

financial incentive for investment in renewable energy technologies such as solar and wind.

- **Tax Incentives:** The German government offered tax incentives and subsidies to households, businesses, and municipalities to invest in renewable energy installations and energy-efficient technologies, such as solar panels and insulation.
- **Green Investment Bank:** Germany established a Green Investment Bank to provide financing and support for renewable energy projects and energy efficiency initiatives, leveraging public and private sector investments in sustainable infrastructure.
- **Outcome:** Germany's Energiewende has led to significant growth in renewable energy capacity, with renewable accounting for a significant share of electricity generation. The transition has created jobs, reduced carbon emissions, and enhanced energy security, demonstrating the potential of aligning fiscal policies with environmental objectives to achieve sustainable energy transitions.

Norway's Sovereign Wealth Fund (Government Pension Fund Global)

- Norway's Government Pension Fund Global (GPF), commonly known as the Sovereign Wealth Fund, is one of the largest sovereign wealth funds in the world. Norway has integrated environmental considerations into the management of the fund to promote sustainable investments and address climate change.
- **CaseStudyHighlights:**
 - **Environmental, Social, and Governance (ESG) Criteria:** The GPF incorporates ESG criteria into its investment decisions, including environmental factors such as carbon footprint, climate risk, and sustainability performance. The fund excludes investments in companies involved in activities such as coal mining, oil sands extraction, and deforestation.
 - **Green Bonds:** Norway has allocated a portion of the GPF's assets to investments in green bonds issued by governments, municipalities, and corporations to finance projects with environmental benefits, such as renewable energy, energy efficiency, and climate adaptation.
 - **Climate Risk Assessment:** The GPF conducts climate risk assessments to evaluate the exposure of its investment portfolio to climate-related risks and opportunities, informing asset allocation decisions and engagement strategies with portfolio companies.
 - **Outcome:** Norway's integration of environmental considerations into the management of the Sovereign Wealth Fund has contributed to promoting sustainable investments, reducing climate risks, and supporting the transition to a low-carbon economy. The fund's approach serves as a model for responsible investment practices globally.

Costa Rica's Payment for Ecosystem Services (PES) Program

- Costa Rica's Payment for Ecosystem Services (PES) program is a pioneering initiative that compensates landowners for conserving and restoring natural ecosystems, such as forests and watersheds, which provide essential environmental services.
- **CaseStudyHighlights:**
 - **Carbon Credits:** The PES program generates revenue through the sale of carbon credits to international buyers, who pay for the carbon sequestration and storage services provided

by Costa Rica's forests. Landowners receive payments for maintaining forest cover and implementing sustainable land management practices.

- **Biodiversity Conservation:** The PES program incentivizes biodiversity conservation by compensating landowners for the protection of critical habitats and endangered species. Payments are tied to specific conservation outcomes, such as the preservation of wildlife corridors and the restoration of degraded ecosystems.
- **Water Resource Management:** The PES program supports watershed protection and water resource management efforts by rewarding landowners for maintaining forest cover and reducing soil erosion, which helps to regulate water flow, prevent floods, and ensure water quality.
- **Outcome:** Costa Rica's PES program has contributed to significant improvements in forest cover, biodiversity conservation, and water resource management. The program has generated revenue for rural communities, reduced deforestation rates, and enhanced ecosystem resilience, demonstrating the potential of market-based mechanisms to align fiscal policies with environmental objectives.

South Korea's Green New Deal

- South Korea's Green New Deal is a comprehensive policy initiative aimed at fostering economic recovery from the COVID-19 pandemic while promoting green growth and addressing climate change. The initiative integrates fiscal policies with environmental objectives to accelerate the transition to a low-carbon economy.
- **CaseStudyHighlights:**
 - **Green Investment:** South Korea has allocated significant funding for green investments, including renewable energy development, energy efficiency upgrades, and sustainable transportation infrastructure. The government offers subsidies, grants, and tax incentives to businesses and households to support green projects and initiatives.
 - **Carbon Pricing:** South Korea introduced a national carbon pricing mechanism, known as the Emissions Trading System (ETS), to regulate greenhouse gas emissions and incentivize emission reductions across industries. The ETS imposes caps on emissions and allows companies to trade emission allowances, providing economic incentives for emissions reductions.
 - **Green Jobs Creation:** The Green New Deal aims to create new employment opportunities in green industries and sectors, such as renewable energy, clean technology, and environmental conservation. The government provides training programs, job placement services, and financial support to workers transitioning to green jobs.
 - **Outcome:** South Korea's Green New Deal has led to increased investments in renewable energy, energy efficiency, and sustainable infrastructure, driving economic growth while reducing carbon emissions and promoting environmental sustainability. The initiative demonstrates the potential of integrating fiscal policies with environmental objectives to achieve green recovery and resilience.

Sweden's Carbon Tax

- Sweden's carbon tax is one of the most ambitious and effective environmental policies in the world, aimed at reducing greenhouse gas emissions and promoting renewable energy use. The

carbon tax is designed to internalize the external costs of carbon emissions and incentivize emissions reductions across sectors.

- **CaseStudyHighlights:**
 - **Carbon Pricing Mechanism:** Sweden implemented a carbon tax on fossil fuels, such as gasoline, diesel, natural gas, and heating oil, based on their carbon content. The tax rate is set according to the carbon dioxide (CO₂) emissions associated with each fuel, providing a financial incentive for individuals and businesses to reduce their carbon footprint.
 - **Revenue Recycling:** Sweden uses revenue generated from the carbon tax to fund investments in renewable energy, energy efficiency programs, and climate adaptation measures. The government also provides tax rebates and incentives for low-carbon technologies and sustainable practices, such as electric vehicles and renewable energy installations.
 - **Emissions Reduction Targets:** Sweden has set ambitious emissions reduction targets in line with its commitments under the Paris Agreement. The carbon tax plays a central role in achieving these targets by encouraging shifts towards cleaner energy sources and behaviors, driving innovation, and fostering a transition to a low-carbon economy.
 - **Outcome:** Sweden's carbon tax has contributed to significant reductions in greenhouse gas emissions while supporting the growth of renewable energy industries and technologies. The tax has been instrumental in decoupling emissions from economic growth and advancing Sweden's transition towards a sustainable, low-carbon society.

United Kingdom's Green Finance Strategy

- The United Kingdom's Green Finance Strategy aims to mobilize investment and finance towards environmentally sustainable projects and initiatives. The strategy integrates fiscal policies with environmental objectives to drive private sector investment in green infrastructure, renewable energy, and climate resilience.
- **CaseStudyHighlights:**
 - **Green Finance Initiatives:** The UK government has launched various initiatives to promote green finance, including the Green Finance Strategy, the Green Finance Taskforce, and the Green Finance Institute. These initiatives aim to develop frameworks, standards, and incentives to encourage investment in sustainable projects and businesses.
 - **Green Bonds:** The UK government has issued green bonds to finance environmentally sustainable projects, such as renewable energy installations, energy-efficient buildings, and sustainable transportation infrastructure. Green bonds provide investors with opportunities to support climate action while generating financial returns.
 - **Regulatory Reforms:** The UK has implemented regulatory reforms to integrate environmental considerations into financial decision-making and reporting. These reforms include requirements for companies to disclose climate-related risks and opportunities in their financial statements and for financial institutions to consider environmental factors in their investment decisions.
 - **Outcome:** The UK's Green Finance Strategy has mobilized significant investments in green infrastructure, renewable energy projects, and climate resilience measures. The strategy has facilitated the transition to a low-carbon economy, supported sustainable development goals, and positioned the UK as a global leader in green finance innovation.

These case studies demonstrate the diverse approaches and strategies that governments can adopt to align fiscal policies with environmental objectives. By integrating environmental considerations into fiscal decision-making and promoting green investments, governments can drive sustainable development, mitigate climate change, and build resilient economies for the future.

7. CONCLUSION

Fiscal policies play a crucial role in shaping resource allocation, incentivizing sustainable behavior, and driving investments in green infrastructure, technologies, and initiatives. By incorporating environmental objectives into fiscal frameworks, governments can advance environmental sustainability goals while promoting economic growth, social equity, and fiscal responsibility.

Key strategies for aligning fiscal policies with environmental objectives include implementing green budgeting frameworks, reforming taxation policies to internalize environmental costs, promoting green investments and incentives, and fostering international cooperation and collaboration.

Case studies from countries such as Germany, Norway, Costa Rica, South Korea, Sweden, and the United Kingdom illustrate successful efforts to integrate environmental considerations into fiscal policies and achieve positive environmental outcomes. These examples highlight the importance of political leadership, policy innovation, and stakeholder engagement in driving sustainable development agendas.

However, aligning fiscal policies with environmental objectives presents several challenges, including short-term focus of fiscal rules, policy coherence and integration, budgetary constraints, and political economy considerations. Overcoming these challenges requires coordinated action, innovative approaches, and long-term vision to reconcile fiscal discipline with environmental sustainability.

In conclusion, by embracing the principles of green fiscal policy, governments can advance a holistic agenda that promotes economic prosperity, environmental stewardship, and social well-being. By integrating environmental considerations into fiscal decision-making processes and promoting green investments, governments can lay the foundation for a sustainable and resilient future for current and future generations.

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