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CONTACT:
ALEXANDRA FORTER SIROTA
919/861-1468
alexandra@ncjustice.org

P.O. Box 28068
Raleigh, NC
27611-8068

www.ncjustice.org

SPECIAL DEALS, SPECIAL PROBLEMS:

An Analysis of North Carolina's Legislature-Approved Economic Development Incentives

BY KENNETH THOMAS

Executive Summary

- North Carolina's statutory incentive programs offer some of the strongest firm performance and accountability requirements in the nation, yet the tendency of the General Assembly to pass "special deals"—those outside of the statutory incentive-granting process—creates a critical short-cut by which companies can avoid these accountability measures.
- This short-cut has resulted in some of the largest incentive deals in the country and creates the possibility of weakening the state's long-term ability to hold to its performance requirements.
- In order to address this problem, legislators should consider refusing to agree to these special deals, except in extraordinary cases, and should certainly never extend incentives to firms that have already reduced employment. The legislature should also reduce intra-state competition by forcing companies to choose a single location within the state before agreeing to incentives.

INTRODUCTION: Economic Development Subsidies in an Economic Downturn

North Carolina's economic development efforts play a critical role in creating jobs, promoting prosperity, and increasing incomes for the state's families. Like many states, North Carolina uses tax incentives and other business subsidies with the intended goals of spurring job creation and investment within the state. Lawmakers are especially eager to wield these economic development tools in the wake of the tremendous job losses of Great Recession. North Carolina lost approximately 227,500 jobs from December 2007 to January 2012. As of February, the state needed 520,900 jobs to make up for those lost jobs and to meet the employment needs of the growing working-age population.[1]

The state unemployment rate rose from 4.8 percent in December 2007 to a peak of 11.7 percent in January 2010, and it has only recently dropped below 10 percent in February 2012.[2]

The jobs outlook in North Carolina has been made worse by state lawmakers' decision to lay off thousands of public workers and severely cut state spending. A whole-budget analysis of the 2011-13 biennial state budget—including tax cuts as well as spending cuts and public-employee layoffs—projected the budget will cause the loss of almost 30,000 jobs throughout North Carolina over the two-year period, with about half of those job losses coming from the private sector.[3] *In addition, the budget cuts have made it harder for North Carolina's unemployed workers to get the education and training they need to qualify for new jobs; higher tuition and fewer class offerings at the state's community colleges and universities have forced some students, especially adult students, to defer or abandon plans to secure new credentials.*

In the face of these challenges, the state has spent significant sums on economic development: according to the most recently available reports from the Department of Commerce, North Carolina's economic development spending totaled $1.2 billion in the 2008-09 fiscal year.[4] *This amount could, for example, support 24,000 workers making $50,000 a year in salary and benefits.*

Given the tremendous need for jobs and state leaders' decision to cut investments in the labor force, it is critical that funds spent on economic development incentives actually fulfill their stated objectives of creating more jobs and better-quality jobs for North Carolina's citizens. Although the state's existing statutory, direct tax incentive programs have earned praise for their targeted nature and strong accountability criteria,[5] *recent high-profile deals requiring special legislative approval have called into question whether the state should provide these "special deals" to companies beyond the incentives already available in existing statute.*

While special deals do give the state's economic development officials additional flexibility beyond the statutory programs in cases of exceptional or unusual development projects, there are several key problems with such deals, including the following: (1) the lack of mandatory, up-front, cost-benefit analyses to ensure that policymakers understand the consequences of prospective incentive deals; (2) the lack of mandatory accountability measures to make sure firms live up to their promises of taxpayer-funded job creation; and (3) the extent to which the use of these deals can actually undermine the state's bargaining position when negotiating with firms for the location and expansion of facilities.

This report reviews several special deals in North Carolina, provides some new metrics for evaluating their efficiency in job creation, and details lessons learned for state policymakers as they consider greater oversight of the special deals process.

Background

A subsidy is any form of government support that lowers a company's cost of doing business.[6] Subsidies are a tool for government to influence private decisions without forcing anyone to take a particular action; governments subsidize activities they wish to promote. Economic development subsidies take two key forms: (1) one-time incentive "deals" involving tax abatements, cash grants, infrastructure development, and job training assistance for specified firms; and (2) entitlement tax incentives, usually involving tax credits for which any firm may qualify by meeting a set of statutorily provided criteria and operating in the state. Both types of incentives are designed to encourage companies to locate new facilities or retain and expand existing facilities within the state, with the ultimate goal of job creation and the promotion of broadly shared prosperity for all of the state's residents.

The extent to which incentives actually live up to these promises of job creation and economic prosperity is an open question, however, and critics of subsidies have argued that economic development incentives are both ineffective and unfair. In terms of effectiveness, most scholarly research on the subject has found little evidence to support the idea that tax incentives produce meaningful economic benefits for communities. This is largely due to two factors. First, firm location decisions are driven almost entirely by the production and transportation costs associated with the community—factors like infrastructure, the presence of key suppliers, and the skill level of the regional workforce. Tax levels make up a tiny portion of this cost structure, so by their very nature, tax incentives can only provide a marginal reduction in firm-level costs. Despite their minimal effects on a firm's cost structure, however, tax incentives can have a meaningful impact on firm profits, and as a result, can contribute to influencing firm location decisions. In doing so, incentives subsidize firm profits—which generally accrue to out-of-state investors—rather than subsidizing new job creation that would not otherwise have occurred.

Indeed, a second major problem is that much of the economic activity "generated" by a program would have taken place in any event. One analysis of North Carolina's early incentive programs found that the subsidies actually induced only 3.6 percent of the jobs claimed for the program.[7] Another study argues that under typical conditions in the United States, incentives induced only about 9 percent of claimed jobs.[8] Even these estimates may overstate the effectiveness of subsidies because it is common for subsidized new investment to displace existing facilities. Examples are abundant in the auto industry[9] and in retail.[10] Related to this is the idea that competition for investment using subsidies is a zero-sum, or even negative-sum, game.[11] States' subsidies offset each other with little net effect on the location of investment, yet governments have transferred substantial sums to private businesses, leaving less money available for other public investments in education and infrastructure.

Critics also question the fairness of tax incentives. Although proponents of incentives argue that subsidizing large-scale job creation benefits the public good, critics question whether discriminating against existing and smaller firms is actually fair. Providing a subsidy to one business puts its in-state competitors at a disadvantage. For example, if a local government defers property taxes for a large national chain store, smaller locally owned businesses that must pay their property taxes will have a harder time competing for customers. There is also the question of fairness to the community. Subsidized businesses benefit from the many programs and services governments provide—public schools, roads, police protection—but they do not contribute their fair share to the funding of these benefits. As a result, families and other businesses must pay more in taxes.[12]

Despite these failures, the pervasive use of these tax incentives makes their outright elimination unlikely in North Carolina, so it is important to understand how the most egregious and ineffective elements of these programs can be reformed to ensure that incentive-backed economic development can live up to its stated goals of creating more jobs and more widely shared prosperity. This involves understanding the flaws in the state's incentive policies and recognizing where these tools can be most effectively deployed.

Past research has shown that properly structured tax incentives can improve employment growth and firm location in disadvantaged and high-unemployment areas.[13] This is especially true when incentives are deployed not as the primary "lure" for footloose, out-of-state corporations, but rather as a last-resort "deal closer" to sweeten the deal with companies already attracted to the economic assets of a particular state but in need of extra assistance to locate in more distressed regions.[14] Finally, incentives clearly produce more effective results when tied both to strong, pre-deal analyses estimating the economic and fiscal impacts of these deals *(see Exhibit 1 for two such methods)* and to accountability measures that require incentivized firms—except in extenuating circumstances—to live up to their promises of job creation or suffer legal sanction and clawbacks.[15] These practices work together to strengthen a state's bargaining position.

EXHIBIT 1: Standardized Methods for Measuring Subsidies

AID INTENSITY

Aid intensity is a useful term borrowed from the European Union's subsidy control system. This technique lets us standardize our comparison of the size of subsidies regardless of how large or small the projects are. One million dollars is a lot of money for a person, and it would be a big subsidy for a call center, which needs little more in fixed investment than computers and phone lines. But a $1 million subsidy for an automobile assembly plant would be tiny because such factories can easily cost more than $1 billion today. There are two standard measures of aid intensity: subsidy divided by investment, usually expressed as a percentage; and subsidy divided by number of permanent direct jobs created, usually given as dollars per job.

To take one recent project—a Facebook data center in Rutherford County, NC—as an example, the company is investing $450 million and receiving an $11.4 million subsidy.[16] Therefore, the company is receiving 2.5% of its investment ($11,400,000/$450,000,000). However, the project will only create 42 permanent jobs at most, so the cost per job is $271,429 ($11,400,000/42). The Google project in Lenoir involves $260 million in state and local incentives over 30 years for the $600 million investment expected to create 210 jobs.[17] This comes to 43.3 percent of the investment and $1,238,095 per job.

PRESENT-VALUE

Present-value is a tool for standardizing amounts paid over a long period of time, such as the 30-year incentive payout of another recent deal involving a Google facility in Lenoir County. Using this example, it is clear that a dollar paid to Google in 2037 is not as valuable as a dollar paid in 2007, and present-value calculations adjust for this fact.

Present-value calculations discount the value of future payments. To take a simple example, let's say the state gives a three-year, $1 million-per-year subsidy to Company X. If we use a discount rate of 10 percent (we assume that it is equally valuable to get $1 a year from now or 90 cents today), then the Year 1 payment is worth $1 million, but the year 2 payment is only worth $900,000 ($1,000,000 * [1-0.1, or 0.9]), and the year 3 payment is worth $810,000 ($900,000 * 0.9). Under those circumstances, we would say that the subsidy is not $3 million, but rather that it has a present value of $2,710,000.

The most important element to this calculation is determining the discount rate, or the assumed amount of decline in the value of money per year. One common choice of discount rate is a benchmark interest rate, and this is what the Organization for Economic Cooperation and Development chose in its project on industrial subsidies during the 1990s.[18] According to OECD officials, the discount rate used for the United States was the interest rate on the 10-year U.S. Treasury bond.[19] Using that discount rate, Thomas calculated the present-value of the Google subsidy package as $140.6 million.[20] This reduces the aid intensity to 23 percent of the investment and $669,489 per job.

While businesses never neglect to calculate present value when they consider an investment project, journalists, subsidy reformers, and even economic development officials often do. In one egregious example of such a failure, New Mexico economic development officials in 1994 claimed that tax receipts for a proposed Intel chip fabrication expansion would exceed the subsidy by $100 million, but they did not factor in present value. According to accountants who performed present-value calculations for The Albuquerque Tribune, because subsidy costs came much sooner than tax revenue benefits, the discounted total was negative, with the subsidy exceeding tax revenue by $1 million to $2 million.[21]

Best practice requires present-value calculation, and it is used in this report when it has already been published elsewhere.

Although North Carolina's statutory programs—primarily the Jobs Development Investment Grant (JDIG) program and the OneNC Fund—are legally required to use of these effective practices when granting incentives to companies, the legislature often passes special deals beyond these direct programs, which can be more problematic and thus less effective.

North Carolina's Statutory and Direct Incentives Programs

Before analyzing the special deals, it is important to ground them in the broader context of the state's economic development incentives. After experimenting with a small-scale program that eventually became the One NC Fund, North Carolina first got into the incentive game in 1996 with the William S. Lee Act (often referred to as the Bill Lee Act), which created a number of entitlement and one-time incentive programs aimed at recruiting firms to invest in North Carolina rather than other states. Originally designed to give higher awards for facilities in poorer counties, in fact most of the credits went to firms locating in richer areas.[22] Moreover, the Bill Lee Act was revised multiple times to allow companies investing in richer areas to qualify for more credits, undermining the law's intention to favor poorer counties.[23]

On January 1, 2007, the NC General Assembly replaced the Bill Lee Act with Article 3J Tax Credits for Growing Businesses. The change made credits available for "company headquarters, air courier services, information technology and services, manufacturing, and warehousing or wholesale trade."[24] Credits are available for job creation, purchase of business property, and the purchase or lease of real estate—the latter only in the poorest Tier 1 counties. The spending for this program is reported with Bill Lee credits through 2008-09 and was estimated in February 2010 to be $24.9 million for 2009-10.

Beyond the 3J tax credits, the primary incentive programs in the state are intended to target one-time deals. They include the Job Development Investment Grant (JDIG) and OneNC programs. Created by the General Assembly in 2002, JDIG is a "performance-based economic development program that provides annual grant disbursements"[25] to a maximum of 25 firms per year in exchange for promised job creation and investment levels. These grants are used both for recruiting new firms to North Carolina and expanding existing firms already located in the state. Since January 2007, JDIG provided 87 awards, of which 72 are still active, for a long-term obligation of $353 million over the next nine to twelve years. As previously stated, these grants are attached to performance criteria and performance measures, which national watch-dog group GoodJobsFirst have applauded for their strength and record of enforcement. In fact, the program scored a 90 out of a possible 100 points for the requirements it makes of investors, including job creation and duration, rules to prevent shifting of jobs within the state being counted as "new," wage standards, and a requirement that jobs provide health care with an employer contribution.[26] In the companion report, "Money-Back Guarantees for Taxpayers," the program scored a perfect 100 for its use of clawbacks, including online disclosure of penalized companies by name and amount repaid.[27]

Originally established as the Governor's Industrial Recruitment Competitiveness Fund in 1993, the OneNC Fund program has undergone several changes (including a change to its current name) and presently provides matching funds to local governments to help with recruitment and expansion. In deals involving the OneNC Fund, local governments combine state and local funds to make payments to companies based on promised levels of job creation, wages, and the tier of county in which the firm is located. The fund is often used as a "deal-closing" device. Local governments are required to match the state's funding, so the total award will be twice the amount of the state award. In 2010, the OneNC Fund made awards of $17.55 million; with the local match, this equals a total of $35.1 million in subsidies. Actual 2010 disbursements were $4.2 million.[28] According to Good Jobs First scorecard, OneNC scored a perfect 100 for its job, wage, and health-insurance requirements, and 95 out of 100 for its clawback provisions.[29]

These statutory programs have advantages over special deals in terms of the state's bargaining power. This is because the fixed nature of the programs creates a clear bottom

line from which the state can negotiate for higher wages and performance targets while capping the maximum amount of incentive available. Special deals by their very nature lack these limits—unless the legislature proactively chooses to incorporate them—and can be more readily abused during negotiations, especially when those negotiations are conducted in secret.

The Problems with Special Deals

While special deals do provide the state's economic development officials with additional flexibility beyond the statutory programs in cases of exceptional or unusual development projects, there are several key problems with the special incentive deals. First, unlike the statutorily established direct incentive grants, special deals do not *require* up-front analysis of the costs and benefits—both economic and fiscal—of prospective deals. Instead, economic development officials may simply ask the legislature to approve incentives for prospective companies in the hopes that someday unspecified benefits will materialize. In practice, the General Assembly has in fact used cost-benefit analyses for many special deals, but the fact that such evaluations are not required is problematic.

Similarly, a key strength of the state's direct incentive programs is their clearly stated performance criteria and clawback mechanisms. The protections require incentivized firms to meet certain standards in terms of the number of jobs created and wage levels or else face the legal obligation to give back the incentive to the state. Since the current legislature cannot legally bind the hands of future legislatures, there is no enforcement mechanism ensuring that legislators will include these performance criteria and clawbacks in the special deals they negotiate with prospective firms.

Thirdly, the use of special deals actually undermines the state's bargaining position when negotiating with prospective companies by allowing companies to extract more in taxpayer subsidies than they would be able to otherwise. Indeed, the special deal scenario is ripe for the type of hostage-taking scenario that the statutory programs were specifically written to avoid. In such situations, companies can use short decision timelines and the threat of locating in other (usually unknown) states to extract high incentive grants from the legislature. This type of deal reinforces the information asymmetries favoring firms: companies have much better information about locations and governments than governments have about companies' cost structure, actual intentions, or possible competitive offers from other locations.[30] Given these information asymmetries, state legislators are at a disadvantage in negotiating with a firm because they lack the necessary information to know how much they can require of the firm and how little an incentive they can give before the firm chooses another state in which to locate. As a result, the maximum incentive amount available and the existence of performance criteria themselves become negotiable in special deals under circumstances that dramatically favor firms over the state government in terms of bargaining power. Indeed, the very possibility of securing a special deal through the legislative process provides firms with a crucial shortcut for avoiding the strict statutory performance requirements and enforcement mechanisms embedded in the existing discretionary programs. Although the legislature has typically—though not always—written strong performance criteria into special incentive deals, this shortcut opens the door to incentives with weakened or absent criteria; this is especially true in the context of a hostage-taking scenario.

Case Studies in Special Deals

Given their problematic nature, it is important to understand how these special deals work out in practice to see what was effective and what was not.

North Carolina's long-standing investments in higher education have formed the basis for attracting a great deal of investment in high-tech sectors such as pharmaceuticals and information technology. Companies such as Dell, Google, Apple, and Facebook have all put down roots in the state. At the same time, several of these projects led the legislature to enact tax breaks specifically designed to attract a single investment. Dell's arrival in 2004 was

wooed with the passage of the Major Computer Manufacturing Facilities Credit. Google in 2006 received the sales tax exemption for sales of electricity and business property.[31] Apple in 2009 was the beneficiary of a revision of the state's apportionment formula for capital-intensive industry, at the cost of not being eligible for other state incentive programs (but still eligible for local incentives).[32] The 2010 legislative session saw the data center sales tax exemption extended to firms investing as little as $250 million, with no prohibition for applying for funds under JDIG or other state programs.[33]

We will now consider several of these special deals.

THE DELL DEAL (2005)

The Dell project was intended to lure a plant for manufacturing computers to Winston-Salem in 2005. For a $115 million investment and a plan to hire 1500 workers, Dell received close to $300 million in incentives.[34] Even at present value, the deal was worth $174.2 million[35] and had an aid intensity of 152 percent or about $116,000 per job. While this project was the subject of intensive analysis by the state Department of Commerce, a joint report by the North Carolina Budget & Tax Center and the Corporation for Enterprise Development showed there were numerous flaws in the state's cost-benefit model. In particular, the model relied too heavily on sales estimates, and it compounded the problem by using the company's estimate of sales rather than developing one of its own.[36]

Dell downsized in response to the recession and announced the closure of the Winston-Salem plant October 2009.[37] Due to clawbacks in incentive deals, the state and local governments only lost a few million dollars overall on the project. Most of the state incentives had not been paid out at the time the closure was announced, and the company repaid at least $1.5 million in state incentives and $26 million in local incentives.[38] However, the effect of using this model was to weaken the state's bargaining position by overestimating the benefits of the plant and overbidding as a result; runner-up Virginia only bid $37 million for the plant and projected far fewer benefits than North Carolina did.[39] Moreover, an aid intensity of over 100 percent is a clear red flag. Indeed, in the European Union, large firms can never receive more than 50 percent of the investment even in the poorest areas.

THE GOOGLE DEAL (2007)

In 2007, Google's data center project in Lenoir received up to $260 million in state and local incentives for a $600 million, 210-job facility. The bulk of this came from Lenoir County and Caldwell County governments agreeing to abate all of the company's property taxes and 80 percent of real estate taxes for 30 years, at a nominal cost of $165 million. Meanwhile, the state's special sales tax exemption was valued at $89 million over the same period, in addition to a $4.8 million state grant.[40] At present value, this deal was worth $140.6 million,[41] for an aid intensity of 23 percent or $669,489 per job. While nothing has been released about the economic modeling for this project, it was negotiated in strict secrecy; officials were not even allowed to mention the company's name.[42] Moreover, after the deal was announced, State Senate President pro tempore Marc Basnight called for a review of the state's incentive use, saying, "I don't have any of the information that would tell us the cost versus the benefit of Google. We have to get that."[43] Secrecy makes it impossible to receive outside input on how realistic incentive offers are; increases the tendency to overbid; and reduces the state's ability to determine whether the incentive is necessary to begin with.

THE APPLE DEAL (2009)

As noted above, Apple received the gift of what is usually called "single sales factor" (SSF) apportionment.[44] This project called for a $1 billion data center; however, it was slated to employ 50 people. According to one estimate, SSF would save the company $46 million over 10 years, while the town of Maiden and Catawba County would add a further $20.7 million in tax incentives over 10 years.[45] Moreover, according to the Legislative Research Division, SSF would save Apple more than $300 million over 30 years, as its rebate would rise from $3 million per year to $12.5 million once the $1 billion was fully invested.[46] No present value calculations are available for this project, but its nominal aid intensity would be 32.7 percent,

at a cost of $6,414,000 per direct job. As with the Dell project, projections for indirect and spinoff jobs were overly optimistic,[47] again calling the Department of Commerce's economic modeling into question and perhaps leading to another instance of state and local governments offering excessive incentives for a project.

THE ALEX LEE DEAL (2011)

In the 2011 legislative session, a special bill was passed to authorize incentives for an unnamed furniture distributor in Davie County. But attached to that bill was a provision allowing Alex Lee Inc. to keep $2 million of an $8 million incentive that it should have forfeited because it cut 50 jobs due to automation.[48] This weakened the state's bargaining position by hinting that its performance requirements will be less binding in the future.

Despite the high price tag of these incentives, the state continues to create new ones, with the previously mentioned expansion of the data center sales tax breaks and the introduction of the Interactive Digital Media Tax Credit both emerging from the 2010 legislative session. Obviously, jobs are not the only benefit from new investment: these projects generate tax revenue and bring cutting-edge technology to the state. Yet at a time when the state is in dire need of both jobs and tax revenue, it is necessary to ask if North Carolina is truly getting good value for its money. Consider that automobile assembly plants in the United States are most likely to get incentives in the $100,000 to$150,000 per job range,[49] and that assembly plants clearly require indirect jobs at supplier plants. By comparison, it is difficult to justify the high level of incentives North Carolina gives to the computer industry.

Conclusion

LESSONS LEARNED

North Carolina does a lot of things right when it comes to economic development. If we compare the state's policies with those recommended by watch-dog groups like Good Jobs First, this is easy to see, with a strong state commitment to a number of key policies. First, the transparency of the state's subsidies has been rated among the best in the country, going well beyond the standards laid out by these groups.[50] Secondly, there is widespread use of clawbacks by both state and local governments and many programs have job-quality standards. Thirdly, the state publishes a comprehensive economic development inventory. Finally, many tax provisions sunset, forcing them to be periodically reviewed. Many on-budget programs have hard caps.

One major challenge of the state's economic development policy is that consistent transparency and monitoring of the job creation impact and greater effort to constrain the use of special deals to attract businesses is needed. Additionally, two of the state's projects are among the 25 largest in the United States for overall incentives between 1999 and 2008: Dell was #15 and Google #25.[51]

RECOMMENDATIONS

While North Carolina follows some of the best policies in the nation, there are several areas where improvements are needed to reduce the use of special deals and, when they are used, to ensure that there are standards in place.

RECOMMENDATION #1. The legislature should largely avoid agreeing to special deals, unless the project needs an unusual degree of flexibility or can play a transformational role in the state's economy (e.g., an auto manufacturing plant that can serve as the basis for a new and large-scale supply chain or industry cluster in the state). Special deals should not be pursued for projects that can be handled using the existing discretionary programs in the state's incentive arsenal, and firms should not be encouraged to consider special deals as a shortcut to avoiding the statutory job creation and investment requirements included in the discretionary programs. Certainly, the legislature should never pass a special deal similar to the Alex Lee incentive, in which a firm receives a subsidy after it eliminates jobs.

RECOMMENDATION #2. In those rare cases in which a special deal is appropriate, the legislature should always attach the strongest possible performance requirements and enforcement mechanisms. The special deal must not become a firm's shortcut to avoiding legally

binding job creation and investment standards. Indeed, a positive aspect of the Dell and Google deals involves the decision of the legislature to extend performance criteria to these two companies. These deals demonstrate the importance of strong accountability and enforcement mechanisms, given that both companies pulled out; ultimately, the clawbacks ensured that the state was able to recover a significant portion of its investment in these companies.

RECOMMENDATION #3. The state should work to reduce competition for a firm's location between regions within the state when special deals are on the table. In the Dell example, the legislature passed a special deal and then allowed the company to pit various communities in the Triad against each other, each making increasingly larger incentive offers in order to win the plant's location. In effect, this inter-regional competition allowed Dell to ratchet up the amount of the incentives it could extract from the local level. To address this, the legislature should require that companies requesting special incentives must select a location prior to the passage of the special deal through the General Assembly.

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North Carolina Justice Center

P.O. Box 28068 ▪ Raleigh, NC 27611-8068
919/856-2176 ▪ alexandra@ncjustice.org

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