

# Chapter 14

## Informal Economy and Legitimacy. The Spanish Case



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**Abstract** The existence of an informal economy is a phenomenon that affects all countries. The amount of the informal economy in Spain in 2013 was estimated to be 196,000 euro millions (18.6% of the gross domestic product; GDP). Although there are several academic studies about the informal economy and its scope, definition, quantification, and positive and negative impacts, the methods used to reduce the impact of the informal economy are not sufficient, and there is an increasing gap between government administration measures and public opinion. For this reason, before adopting a measure to combat the informal economy, it is necessary to analyze the legitimacy of the measure. Lack of, or inadequate, legitimacy means that the measure does not accord with social norms and values, and this could lead to its failure. We carried out research to rationally search for solutions that would end the existence of the informal economy; the research employed previous analyses of the legitimacy of the problem, the effectiveness of measures to combat it, and the relationship between legitimacy and effectiveness. To meet this objective, an empirical online study was carried out between November 2013 and January 2014, via questionnaire; the questionnaire was answered by 745 people and the data were statistically analyzed.

**Keywords** Informal economy · Public administration · Economic distortions · Effectiveness · Pragmatic legitimacy · Moral legitimacy · Cognitive legitimacy · Negative effects · Government · Economic balance · Payment · Underground economy

### 14.1 Introduction

The existence of an informal economy is a phenomenon that affects all societies, but its weight varies from one country to another. According to recent research (Schneider, 2013), in Europe the size of the informal economy could be nearly 2.5 trillion euro,

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which is 18.5% of the gross domestic product (GDP). In Spain the size of the informal economy could be 196.000 million euro; (18.6% of the GDP). A phenomenon of this magnitude has generated several studies, but these are characterized by their heterogeneity. Definition of the concept was explored in studies by Capecchi (1983); the European Commission, Employment and Social Affairs (2004); Feige (1990); Gallego (1995); Ruesga and Montero (1998); Schneider (2005); *Undeclared Work in an Enlarged Union*, Brussels: Círculo de Empresarios, (2010); and the European Commission (2004). The resources used to quantify the informal economy were investigated by Anghel and Vázquez (2010).

This context becomes more complex. The study of this phenomenon, in regard to finding solutions to eradicate it and avoid its impact, has shown that informal economies increase societal inequality and lead to economic distortions; lead to problems in measuring economic variables; and lead to incorrect ratings of countries as members of the G7, G20, etc. For these reasons efforts have been made to eradicate the informal economy (Rajeev & Sayan, 2012).

Despite the efforts made to combat informal economies, not only have the measures used failed, but there is also a clear gap between the actions taken by administrations to eradicate the informal economy and the opinions of citizens on these measures. In this sense, taking as an example the Spanish case, according to data from the Center for Sociological Research of Spain (CIS, 2007), the perception that the administration has increased their efforts in the fight against fraud has risen (2007, 44.7%; 2003, 41.5%; 1999, 40.1%). However, this improvement seems insufficient. But 40% of the citizens understand that the administration devotes little or very little effort to this issue.

This leads to a need to find solutions to this problem, because the techniques employed have not been adequate to eradicate fraud (Vera, 2008). One possible solution, proposed by different authors, is to place a limit on cash, because it is a means of payment characterized by anonymity (Bernal, 2001), and it is used for the settlement of transactions in the informal economy (Quirós, 1990). It is necessary to consider the possibility of replacing cash by electronic payments, which are characterized by their lower cost (De Grauwe, Rinaldi, & Van Cayseele, 2006; Trigo, 2012).

However, before adopting a measure, it is necessary to analyze its legitimacy, because lack of legitimacy or inadequate legitimacy means that the measure does not accord with community norms and values, and this can lead to failure (Díez, Blanco, & Prado, 2010). The rational search for solutions to a problem (the existence of the informal economy), with previous analysis of the legitimacy of the problem, the effectiveness of measures employed to combat it, and the relationship between legitimacy and effectiveness, justifies the relevance of the present study. Although various measures to combat this problem have been established in recent years, the informal economy has not been eradicated, and in Spain the informal economy has accounted for close to 20% of the official economy for the past 20 years (Arrazola, De Hevia, Mauleón, & Sánchez, 2011). This forces us to seek solutions that are not based on negative effects. The solutions need to be based on the study and previous analysis of this phenomenon; specifically, study of the legitimacy of the proposed solutions.

## 14.2 Conceptual Framework

As Tanzi (2002) details, the consequences of the informal economy representing a high proportion of the economy are as follows:

- Inequality: although there are people who do not pay taxes and there are others who do so, all of them receive the same services.
- Economic distortions: because it follows logically that a reduction of state incomes through non-payment of taxes will inevitably result in trouble financing government services, or in reductions in the quality of these services.
- Problems in measuring economic variables: a clear example would be the unemployment rate, because the data with which the government works will possibly be erroneous, and actions taken, based on this indicator, to try to solve the problem will also be erroneous.
- Incorrect ratings for countries as members of the G7, G20, etc.

These factors pointed out by Tanzi (2002) are similar to those noted by Schneider (2007). Schneider argues that these are powerful reasons why politicians in many countries in Western Europe should worry about the informal economy, as it affects the size as much as the growth of the economy.

Although several studies point to positive effects of the informal economy (Círculo de Empresarios, 2010) – especially from a short-term perspective, e.g., ease in obtaining salary for employees; lower costs for the employer; and the perception of reduced need for unemployment benefits and other social support measures, reality points to several negative effects that, according to our present study, are seen by society:

- The informal economy affects the price level of the legal market. Reducing an employer's costs of complying with regulations can lead to products being offered at a lower price than the prices offered by those who do incur such expenses. We found that 75.7% of our respondents agreed/strongly agreed that the informal economy affects the level of market prices.
- The informal economy affects the level of wages in the legal market. The existence of cheaper labor forces jobseekers to reduce their wage claims (an employer's saving on social costs and tax would mean that regular workers could be dismissed); 82.2% of our respondents agreed/strongly agreed that the underground economy affects the level of wages in the legal market.
- The underground economy affects the official unemployment rate. As there is no regularized employment, there will be a distortion between the official unemployment rate and the actual number of unemployed people; 86.4% of our respondents agreed/strongly agreed that the underground economy affects the official unemployment rate.
- The informal economy affects the income of the State. The "Closing the European Tax Gap" report (Murphy, 2012) figures the amount that Spain no longer enter the year as a result of fraud arising from the irregular economy 72,700 million euros (data for 2009). This represents 16.6% of total public expenditure and 70.5% of health spending; 92.3% of our respondents agreed/strongly agreed that the underground economy affects the income of the State.

Based on these data, the perception that the existence of the informal economy produces negative economic effects was confirmed.

We looked at whether there was a relationship between this degree of knowledge of the negative effects of the informal economy and the present intention of the respondents to change their attitudes to undeclared income. However, the result was negative, meaning that, in general, although respondents knew the negative effects of the existence of the informal economy, this did not cause them to change their intention to comply with fiscal regulations.

In this sense, Jiménez and Martínez (2013) state, after analyzing various statistics about opinions and fiscal attitudes of Spaniards in 2011 (IEF, 2012), that these data could reflect two situations. First, the data indicate that the authorities may have some room to act more decisively in the fight against tax fraud, given that the citizens support this action. Secondly, the data demonstrate the existence of a double standard in Spanish society in relation to this topic: two-thirds of the population find no justification for tax evasion, but studies indicate that fraud is widespread and accepted by our citizens.

This double standard was confirmed by our finding that, after analyzing the relationship between the effects of the informal economy and intent to pay, we observed that the decision on whether to pay tax was affected in a negative way by the fact that the informal economy affected the price level of the legal market. In this sense, as one of the effects of the informal economy is lower prices for consumers, this effect would encourage wanting to comply with tax regulations through payment if prices were competitive. However, the reality indicates that consumers continue to make informal payments.

The existence of a phenomenon such as the informal economy, about which we have already shown various negative effects, makes it necessary to adopt measures to combat it. Jiménez and Martínez (2013) reported on the classification established by the Eurofound (2013), according to which we can distinguish two types of actions. First, dissuasive measures, which are based on the detection and punishment of a breach. Second, incentive measures, which focus on promoting the declaration of income, increasing the social commitment to the official economy (tax morality). These two measures each consist of three types: preventive, curative, and those that promote greater engagement of citizens.

For controlling the existence of the shadow economy, the traditional administrative control model in Spain includes two types of actions:

- Automated checks, using software tools, based on information Cross-checking systems and systems created by the tax management department.
- Checks carried out by entities of the intensive inspection department.
- On balance, the measures taken by the Spanish Tax Agency (AEAT) in the investigation of tax fraud are inadequate, and therefore new measures have been adopted to improve the system. The following defects have been identified by Vera (2008):
- The control model based on intensive administrative inspection procedures is inappropriate for addressing new types of fraud.
- The Spanish Tax Agency (AEAT) has tried to combat increasingly organized and complex phenomena with traditional management solutions that were designed to address simpler situations of personal failure; these solutions almost always lack the structured nature needed to combat existing fraud networks.

- Although there have been significant advances in the past 4 years, following the fraud prevention plan, the Spanish Tax Agency (AEAT) still lacks a stable research model that is sufficiently defined.
- The traditional model of criminal charges related to tax fraud is inadequate.
- The penal response regarding criminal activities related to tax fraud is highly unsatisfactory.

The central principle of institutional theory is based on the concept that organizations need to gain and maintain legitimacy to survive (Deephouse, 1996; DiMaggio and Powell, 1983; Suchman, 1995). As pointed out by Zaheer (1995), the organizations that survive for long periods are those that are best adapted to environmental pressures, acting in accordance with established standards and social values. Many organizations have failed not because their products were bad or because they lacked resources, but because they lacked legitimacy or their legitimacy had deteriorated (Ahlstrom and Bruton, 2001; Chen et al., 2006).

Thus, there is a relationship between legitimacy and effectiveness. In the academic literature on legitimacy, different research studies show a direct relationship between the legitimacy of an organization and its effectiveness. According to Cruz et al. (2014), legitimacy improves the stability and comprehensibility of organizational activities, and shows that the organization exists within an institutionalized system of beliefs and values. Legitimacy is a factor that serves to improve opportunities when an organization acquires the resources necessary for survival and growth, such as capital, technology, management teams, other staff, customers, and ? (Aldrich and Fiol, 1994; Meyer and Rowan, 1977; Scott, 1995; Zucker, 1987).

The organizations that seem desirable, right, or appropriate for their stakeholders are more likely to continue with their activities, and are therefore more likely to survive (Díez et al., 2013). Although some organizations may try to access resources by unethical or illegal actions, over time this approach can create problems for the organizations, limiting their survival and growth, and even hindering future attempts to increase their legitimacy and achieve their objectives (Díez et al., 2010). Interest groups require that organizations comply with certain rules of socially acceptable behavior. Legitimacy leads to the continuity of organizational activities, because stakeholders are more likely to support those organizations that seem desirable, right, or appropriate (Parsons, 1960). In addition, legitimacy improves the results of organizations, and it has been shown that it is necessary for an organization to adopt a process of legitimacy, considered as a set of actions whose development allows both the obtaining and the maintaining of legitimacy (Diez, Blanco, & Prado, 2013, 2014).

Analysis of the legitimacy of the shadow economy and the effectiveness of measures to combat it can be considered according to two points of view. First, the legitimacy of this phenomenon must be considered, in which, as pointed out above, greater legitimacy of the shadow economy hinders the effectiveness of measures that were approved to combat the phenomenon. Second, the legitimacy of the measures used to combat the phenomenon must be considered, so that if, in implementing these measures, the administration shows an interest in reinvigorating these measures through the provision of legitimacy, there will be a greater chance of success.

The development of the theory of legitimacy has three dimensions. First, pragmatic legitimacy, which is limited to the interests of the environment (Cruz et al., 2014).

Organizations that maintain direct relationships with their environment can have authentic power relationships. Stakeholders show their support for such an organization not because it aims for great goals, such as high profits, but because they observe that the organization is responsive to their interests. In this case, the organization tries to ensure that its policies and goals are positively related to their environment, especially their stakeholders, generating a materialistic relationship of power and dependency. For this group, the responsiveness of the organization to its interests is more important than the obtaining of large profits. Support for the actions of the organization will be considered to come from a person who demonstrates and shares their interests, values, and beliefs, and who is honest, desirable, authentic, and reliable (Suchman, 1995). This support can be derived from compliance with rules, standards, and expectations generated by governments, professional groups, other associations, or the organization itself.

This support can be analyzed from the perspective of the informal economy, which interacts with citizens. In an economic context where there is an informal economy that responds to what the citizens demand, we speak of the existence of pragmatic legitimacy, since the interests of the citizens are incorporated. Thus, in those countries where the sectors favored by the existence of an underground economy have greater weight, measures to combat the underground economy are complex.

Second, we can speak of moral legitimacy, which, unlike pragmatic legitimacy, does not rest on judgments about whether the evaluated objective benefits the evaluator, but rather on whether the evaluator believes that the evaluated objective is the right thing to do, regardless of whether they benefit from it. A system in which there is an informal economy shows moral legitimacy when its stakeholders (citizens) consider the objectives and the actions developed to achieve these objectives are desirable. Moral legitimacy is usually analyzed by evaluating the desirability of the outputs, techniques, and procedures used to achieve the objectives (Scott, 1977; Scott & Meyer, 1991). As established by Suchman (1995), moral concerns are more resistant to external manipulation than merely pragmatic considerations.

Moral legitimacy of the underground economy is achieved when a society perceives that the positive effects of this economy outweigh the negative effects (understanding these positive effects from a global perspective is not particularly useful). It is in this context that the effective implementation of measures to combat the underground economy is more complex than when the underground economy is perceived to lack moral legitimacy.

Third, cognitive legitimacy refers to the adequacy of techniques and procedures used to achieve an organization's objectives. The desirability of the target, or the actions taken to achieve the target, is not as important as the adequacy of the technique used in the actions leading to the achievement of the target. The difference between moral and cognitive legitimacy has been discussed by several authors (Zeitl et al., 1999), with differentiation considered in regard to the use of methods, models, practices, assumptions, knowledge, ideas, realities, and concepts that are widely accepted and considered useful and desirable by the body of professionals and scientific experts under which an organization operates (Aldrich & Fiol, 1994; Hunt & Aldrich, 1996; Scott, 1995; Suchman, 1995; Zimmermann & Zeitl, 2002). Thus, cognitive legitimacy is a kind of legitimacy based on knowledge rather than on interest or evaluation (Aldrich and Fiol, 1994). The informal economy has cognitive legitimacy in contexts where its economic activity is perceived as the best way to achieve socioeconomic stability.

### 14.3 Sample and Methodology

The universe of this research is specified in people residing in Spanish territory, following the approach used in other surveys about the informal economy (CIS, 1997). Before we measured the variables, we described the methodology used in the selection of the sample.

At this point, part of the tax fraudster indirectly clear from the data presented annually by the Ministry of Finance (AEAT, 2013) profile as well as that of other organizations that analyze the impact of specific measures such as, for example, made by the union of technicians of Finance after the end of the campaign “tax amnesty” (GESTHA, 2012). It is seen to large enterprises, whose turnover exceeds 100 million per year, the largest tax fraudster. It is responsible for 26% of detected fraud. This difference in attitudes toward effective compliance with tax obligations justifies our decision not to restrict the selection of the sample to a specific respondent profile; thus, random sampling was applied.

Table 14.1 summarizes the characteristics of the study to achieve the objectives from a theoretical point of view.

After reviewing various methods, we used a survey as the research strategy for the collection of information. Before we used the survey interviews, we confirmed them with experts in the field. The scales used to measure each of the considered variables were the Likert-7 type, in which ‘1’ means ‘strongly disagree’ and ‘7’ means ‘totally agree’. We selected this scale after considering several alternative options.

### 14.4 Results

The first analysis of the results (Table 14.2) seemed to reflect direct opposition to the informal economy by society, with the majority of respondents believing that:

- It is not justifiable to declare only part of your income to pay less tax or to provide false information to obtain benefits to which you are not entitled (moral legitimacy)
- You should not charge for a service without declaring the income, and you should not use lower-price services when you know that the income will not be declared (pragmatic legitimacy)

**Table 14.1** Characteristics of the study

|                                  |                                      |
|----------------------------------|--------------------------------------|
| Universe                         | Spanish population over 18 years old |
| Sample                           | Spanish population over 18 years old |
| Geographic area                  | National (Spain)                     |
| Method of collecting information | Online questionnaire                 |
| Sample error                     | 3,59%                                |
| Confidence level                 | 95%; $Z = 2$ ; $P = Q = 0.50$        |
| Sampling procedure               | Random sampling                      |
| Number of surveys                | 745                                  |
| Period of information collection | November 8, 2013 to January 28, 2014 |

**Table 14.2** Results for legitimacy, shown on Likert scale, where ‘1’ means ‘strongly disagree’ and ‘7’ means ‘totally agree’

| Dimension     | Item   | 1    | 2    | 3    | 4    | 5    | 6    | 7   |
|---------------|--|------|------|------|------|------|------|-----|
| Moral         | It is justifiable to declare only part of the income to pay less tax   | 42.1 | 16.8 | 9.0  | 8.9  | 9.4  | 7.7  | 6.2 |
| Moral         | It is justifiable to provide erroneous information to obtain benefits to which you are not entitled              | 66.0 | 14.6 | 4.7  | 5.1  | 3.2  | 3.0  | 3.4 |
| Pragmatic     | I am interested in being able to charge for a service without declaring the income                               | 47.8 | 15.3 | 8.9  | 10.2 | 7.2  | 5.1  | 5.5 |
| Pragmatic     | I am interested in having services at a lower price, even though I know that these revenues will not be declared | 35.3 | 17.2 | 9.7  | 12.1 | 8.3  | 9.0  | 8.5 |
| Moral         | The underground economy is an efficient way to achieve economic and social balance                               | 49.9 | 21.5 | 10.1 | 7.7  | 4.4  | 2.7  | 3.8 |
| Moral         | An economic system in which there is no underground economy would be impracticable                               | 38.5 | 20.4 | 11.8 | 12.9 | 6.4  | 4.3  | 5.6 |
| Effectiveness | The measures that are approved to combat the underground economy will be rejected socially                       | 13.2 | 16.4 | 20.3 | 19.2 | 10.3 | 11.0 | 9.7 |
| Effectiveness | Ways will be sought to avoid compliance with measures adopted to combat the underground economy                  | 27.4 | 24.2 | 19.3 | 13.7 | 5.5  | 5.2  | 4.7 |

- The informal economy is not an efficient way to achieve economic and social balance, and an economic system in which there is no informal economy would be viable (cognitive legitimacy).

Also, the majority of respondents said they declared 100% of their income and did not make payments to people knowing that the amount would not be declared.

Thus, we see that, in principle, the informal economy would not be legitimate from the perspective of the three dimensions of legitimacy targeted by Suchman (1995). Pragmatic legitimacy, according to which organizations maintain direct relationships with their immediate surroundings, can turn into real power relations, where some groups are able to achieve great power over the organization. Stakeholders show their support for the organization because it does not aim for big goals, including high turnover, but because they observe that the organization is being responsive to the interests of the stakeholders. In economies where there is an underground economy that responds to what citizens demand, we speak of the existence of pragmatic legitimacy, which incorporates the interests of the stakeholders. Thus, in those countries in which sectors that are favored by the existence of the underground economy have greater weight, measures that are successful in combatting the underground economy will be complex.



Moral legitimacy, unlike pragmatic legitimacy, does not rest on judgments about whether the evaluated objective benefits the evaluator, but rather on whether the evaluator believes that the evaluated objective is the right thing to do, regardless of whether they benefit from it. Thus, a system in which there is an underground economy shows moral legitimacy when its stakeholders (citizens) consider that the objectives and the actions developed to achieve them are desirable.

Cognitive legitimacy, unlike moral legitimacy, corresponds to the fact that the techniques and procedures used to achieve the objectives are perceived to be appropriate. The desirability of the target, or the actions taken to achieve the target, is not as important as the adequacy of the technique used in the actions leading to the achievement of the target. Thus, the informal economy would have cognitive legitimacy in contexts where shadow economic activity is perceived by different social sectors to be the best way to achieve socioeconomic stability.

But personal rejection of the informal economy by the respondents is not valid, as it was observed that the majority of respondents (70.9%) believe that they will try to avoid compliance with measures adopted to combat the informal economy. And 80.1% of the respondents stated that they did make payments knowing that the person receiving the payment would not declare this income.

It has been observed that, regarding the effectiveness of measures to combat the black economy, there is a positive relationship between the effectiveness of these measures and inspections of finance records in sectors with high rates of a shadow economy (Table 14.3). In past years, there has been a negative relationship between the effectiveness of these measures and the approval of tax amnesties to regularize undeclared money.

With these data it can be concluded that, although most of the measures approved in the Law 7/2012, 29th October, Intensification of Actions in the Prevention and Fight against Fraud have been regarded as useful (except for the extraordinary regularization, in the form of a tax amnesty, which has been controversial since its announcement), the carrying out of inspections only in sectors with high rates of a shadow economy is an effective measure.

Our research must be related to the finding of the CIS study (2013) that 66.9% of respondents believed that the means used to combat the informal economy were few or very few. Currently, however, measures to combat the perceived existence of the informal economy are seen to be insufficient. Increased inspections in sectors such as would help to reduce the informal economy.

The responses in our study have to be contextualized, considering that society perceives that large organizations do not practice fraud (the respondents perceived that there was greater compliance with tax obligations on the part of companies (62.7%) than by individuals (44.7%). It is this perceived lack of compliance by certain sectors which allows a social majority to feel legitimized by not complying with tax law, as detailed below.

**Table 14.3** Relationship between legitimacy and effectiveness

| Relationship                         | Beta          | T-value       |
|--------------------------------------|---------------|---------------|
| Moral legitimacy → Effectiveness     | 0.021         | 0.239         |
| Pragmatic legitimacy → Effectiveness | 0.069         | 0.824         |
| Cognitive legitimacy → Effectiveness | <b>-0.356</b> | <b>-6.341</b> |
| $R^2 = 0.104$                        |               |               |

## 14.5 Discussion, Conclusion, and Implications

The existence of a phenomenon such as the informal economy, with negative effects, has led to a reaction from the Spanish government in that they have adopted different measures to combat this phenomenon. A first analysis of our study's results shows a direct rejection of the informal economy by society. The majority of respondents believe that:

- It is not justifiable to declare only part of their income to pay less tax, or to provide misinformation to obtain benefits to which they have no right (moral legitimacy)
- It is not justifiable to pay for a service when the service provider does not declare the income, or knowing that there are services for which they can pay a lower price, it is not justifiable to use these services when they know that these earnings will not be declared (pragmatic legitimacy)
- The underground economy is not an efficient way to achieve economic and social balance, and an economic system in which there is no underground economy would be viable (cognitive legitimacy).

In addition, most of the respondents say they declare 100% of their income and make payments not knowing that whoever comes will not testify. However, this personal rejection of the underground economy by the respondents seemed to be invalid, as the majority of the respondents (70.9%) believe that ways should be sought to avoid compliance with measures adopted to combat the underground economy, and most respondents say they have made payments, on occasion, knowing that the recipient would not declare this income.

The information above matches the data presented in this chapter on the level of the shadow economy in Spain (18.6% of GDP). The data from our study, together with data already reported by other authors, e.g., Anghel and Vázquez (2010), identifies difficulties in measuring the informal economy by direct methods. Schneider (1994, 1997, 1998) have reported that it is exactly because of the lack of cooperation by agents that it is difficult to obtain estimates of the size of the informal economy, because respondents rarely reveal fraudulent behavior, or else they provide lower or imprecise estimates of such behavior.

It has been confirmed that society perceives the underground economy to be an efficient way of achieving economic and social balance, and society also perceives that an economic system in which there is no underground economy is not viable. For these reasons, the measures approved to combat the underground economy will be rejected by society and ways will be sought to avoid compliance with such measures.

Moreover, the data obtained in our study shows that the weight of the cognitive dimension of legitimacy is diluted by the measurement of overall legitimacy. Thus, the weight of other dimensions of legitimacy means that legitimacy in general has no influence on the effectiveness of the measures taken to combat the underground economy.

In conclusion, it is necessary to reorientate the fight against tax fraud in Spain, focusing on efforts to eradicate the perceived legitimacy of the underground economy in Spanish society. For this purpose, it is necessary to encourage compliance with taxation laws (especially by promoting the use of electronic invoices, to prevent payments for goods and services being made on the black market.). It is also necessary to eliminate existing facilities that allow fraud to be committed (by the gradual replacement of cash payments by electronic payments).

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