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Fiscal Federalism: Circling the Wagons Favouring Public Finance System

Ms. Shailja N. Vyas
Research Scholar at Sardar Patel University of Police,
Security and Criminal Justice, Jodhpur, Rajasthan, India.
E-mail address- vyashailja25@gmail.com

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ABSTRACT

"THE COUNTRY NEEDS PHYSICAL DISCIPLINE TO BUILD A STRONG ECONOMY FOR SOCIAL JUSTICE."

In light of the statements made by Mrs. Smriti Irani, it is evident that fiscal federalism is a fundamental concept in democratic nations such as India and the USA. The term fiscal federalism refers to the financial interactions among governmental entities in a federal framework. However, a common misunderstanding persists regarding the applicability of 'federalism' in this context. It is crucial to recognize that the term does not exclusively pertain to countries with a federal political system; it also applies to unitary political frameworks. Observations indicate that financial relationships across various levels of government, particularly concerning the allocation of taxation and expenditures, are also practiced informally in unitary states. This observation broadens the understanding of fiscal federalism as a universally relevant concept. Consequently, fiscal federalism, as a component of public finance, addresses the economics involved in government expenditure and taxation policies applicable to any nation with a decentralized governance structure. The present inquiry will explore aspects related to taxation policies, public spending, grants, and a range of other regulatory functions to gain a nuanced understanding of the topic. Further, the analysis will consider both vertical and horizontal imbalances, alongside various contemporary challenges affecting the fiscal regulatory system. While this study will concentrate on the Indian political landscape and its federal structure, a comparative evaluation with the fiscal regulations in the USA will be presented in a brief concluding section.

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1. INTRODUCTION

In the intricate tapestry of governance, federalism emerges as a pivotal construct, embodying the dual principles of autonomy and collaborative regulation. This ideological framework is intricately woven through a constitutional architecture, meticulously delineating responsibilities aimed at fulfilling collective aspirations through a synergistic governmental apparatus. The genesis of contemporary federalism can be traced back to the United States in the late 18th century, marking a significant evolution in political thought.

Typically, federalism is categorized by the diverse roles undertaken by the government, encompassing both political and economic spheres. Intriguingly, even systems adherent to a unitary model often manifest the core tenets of federalism with remarkable clarity. The quintessential mandate of governance, irrespective of its structure, lies in the astute identification and adept cultivation of a framework that aspires to address the diverse needs and preferences of its citizenry. Consequently, federalism is fundamentally anchored in three cardinal functions: allocation, stabilization, and distribution, all of which coalesce to enhance societal welfare and facilitate the overarching goal of communal prosperity.[1]

Fiscal federalism is a specialized area of public finance and economics that focuses on the effective distribution of functions and financial instruments within a federal system. In other words, it examines how government expenditures and revenues are appropriately allocated across different levels of government. Recently, there has been a notable revival of interest in fiscal federalism across the globe. This resurgence has been embraced by both constitutionally defined federations and unitary governments, encompassing a variety of developed and developing nations. The advantages associated

[1] Ariyo, A., & United Nations Economic Commission for Africa. (2003). *Theories of federalism. UN. ECA Ad-hoc Expert Group Meeting (October 7–9, 2003, Addis Ababa, Ethiopia).*

with decentralization have led to a more efficient distribution of power among sub-central government entities. In the framework of fiscal federalism, federal fiscal arrangements—including tax and expenditure assignments, intergovernmental transfers, and grants—are determined based on normative economic principles. The effectiveness of fiscal federalism is not solely dependent on a federal constitution; rather, the degree of decentralization is a critical factor in shaping more federal fiscal relationships. Decentralization plays a crucial role in fiscal federalism, as excessive centralization has been identified as a significant factor in the collapse of the Soviet Union. The optimal institutional arrangements for public services, which fall under fiscal federalism, combine the benefits of decentralization with economies of scale, resulting in enhanced welfare for democratic governments. According to the decentralization theorem[2]fiscal federalism ensures that public services are provided in response to the diverse demands present within a federation.

The traditional fiscal federalism theory provides a normative framework that outlines how different levels of government should be assigned specific functions and the appropriate fiscal tools to execute these responsibilities.[3] This theory suggests that the central government has the primary obligation to ensure macroeconomic stability and fair income distribution to promote social welfare. Additionally, the decentralization of government functions fosters a sense of accountability among lower levels of government, which are empowered to carry out these duties, albeit within a limited scope. Fundamentally, the study of fiscal federalism focuses not on the debate between centralization and decentralization but on the significant roles that various government layers play in influencing a nation's financial relations.

2. CONCEPTUAL FRAMEWORK

In the realm of fiscal federalism, one encounters a plethora of economic tenets that are meticulously orchestrated to enhance the operational efficacy of the public sector within a complex, multi-tiered decision-making framework. Central to the discourse on fiscal federalism are the pivotal questions surrounding the allocation of financial resources and responsibilities across the various strata of governance. Furthermore, it is imperative to devise robust mechanisms and instruments, alongside the implementation of economically prudent strategies, aimed at ameliorating conflicts and rectifying fiscal

[2] Oates, W. E. (1972). *Fiscal federalism*. New York, NY: Harcourt Brace Jovanovich.

[3] Musgrave, R. A. (2007). *Theory of public finance*. New York, NY: McGraw-Hill. *(Original work published 1910)*

discrepancies that emerge within the societal construct. Such an analytical approach is essential for fostering a harmonious interplay among disparate governmental levels, thereby ensuring a more equitable distribution of fiscal responsibilities and benefits.

The intricate examination of the principles underpinning fiscal federalism, since its conceptual genesis articulated by the esteemed Charles TieBout, has invariably revolved around the scrutiny of welfare enhancements that arise from the process of fiscal decentralisation. This notion has historically been perceived through the lens of political democracy, as it fundamentally addresses optimal institutional frameworks concerning the allocation and distribution of public goods and services, which in turn profoundly affect social welfare dynamics. “The comprehensive national marketplace for both factors and products facilitates the establishment of a framework for equitable pricing, thereby engendering a more effective allocation of resources than what would be achievable in a fragmented economic landscape”[4]. “Moreover, efficiency gains are concurrently derived from the internal competitive restrictions and the presence of a unified national market for both factors and products”[5].

In a country like India, governmental units exhibit a complex relationship that can be categorized as either vertical or horizontal, which refers to intergovernmental or inter-jurisdictional dynamics. While a significant amount of literature on fiscal federalism mainly emphasizes the concept of cooperative federalism, it is important to recognize that the interactions among multi-level governmental units are fundamentally competitive. Such competition is not inherently negative; when managed effectively, it can lead to enhanced public welfare. For example, in a market setting, various governmental units may compete by offering a range of public services at different tax rates, thereby attracting attention from businesses in a free market. It is essential to ensure competitive equality among governmental units—akin to the presence of many small firms in a competitive equilibrium—while also appropriately weighing costs and benefits within each jurisdiction, as highlighted by Breton (1987).[6] The Tie bout hypothesis suggests that, similar to how competition among firms facilitates the efficient supply of

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[4] Tapas, K. S. (2004). *Reforming state finances: An agenda*. New Delhi, India: National Institute of Public Finance and Policy (NIPFP).

[5] Singh, M. G. (2000). *The political economy of centre-state fiscal transfers in India* (Working Paper No. 107). California, CA: Centre for Research on Economic Development and Policy Reform, Stanford University.

[6] Breton, A. (1987). *Towards a theory of competitive federalism*. *European Journal of Political Economy, 3*, 263–329.

goods in a free market, competition among local governmental units promotes the efficient delivery of public goods and services. Overall, this discussion underscores that the dynamics between governmental units in a nation do not necessarily reflect cooperation.

Fiscal federalism operates on the principle that responsibilities should first be decentralized before financial resources are allocated. According to a common understanding of fiscal federalism, certain responsibilities, particularly those related to national interests such as foreign investments, international loans, significant spatial externalities, and economies of scale, should be managed by the central government. Conversely, local functions such as sanitation, public roads, and street lighting should be overseen by subordinate governments. Essentially, government agencies should allocate responsibilities and their associated expenditures based on the geographical benefits linked to each function. This approach can lead to a more equitable distribution of public goods that cater to local demands, ultimately enhancing social welfare. Furthermore, both local entities involved in service delivery and the national government can become more accountable and responsive as they improve fiscal discipline. Additionally, effective fundraising at the grassroots level alleviates the financial burden on national government resources.

3. FISCAL FEDERALISM IN INDIA

The current landscape of fiscal federalism in India reflects a complex interplay of historical influences. The origins of fiscal federalism can be traced back to the establishment of the East India Company in 1600 CE, which was granted specific trading rights in India through its charter. The company subsequently established several trading hubs, with Bombay, Madras, and Calcutta emerging as principal settlements, later recognized as presidencies. In 1773, legislation was enacted that empowered the Calcutta presidency, placing it above the other two, marking a significant step toward the formation of a governmental framework.

However, the landscape evolved with the introduction of the Charter Act of 1833, which centralized fiscal and legislative authority by exclusively placing it in the hands of the Governor-General of Bengal, who became the Governor-General of India. This centralization was a significant shift in governance, particularly as it coincided with the British Crown assuming direct control over Indian administration in 1858. The budget system and the concept of a financial year were solidified during this period, with the budget for 1860-61 laying the groundwork for the ideas of union, state, and concurrent powers.

Further developments occurred with the introduction of the diarchy system under the Government of India Act of 1919, a result of the Montagu-Chelmsford reforms, which allocated certain powers between the central and provincial governments while allowing the central authority to legislate for the entire country. This arrangement led to a sharing of revenue sources between the central and provincial domains. The Government of India Act of 1935 ultimately shaped the federal structure of finance and governance, integrating features of the parliamentary system and delineating legislative and financial responsibilities between provincial and federal governments. This Act also provided detailed provisions regarding the allocation and distribution of resources and grants-in-aid.

3.1 FISCAL RELATION OF STATE AND UNION IN INDIA

In India, an analytical assessment of the fiscal dynamics between the central and state governments necessitates an examination of their respective authorities regarding the imposition and collection of taxes. The country operates within a federal financial framework that delineates revenue generation and expenditure aimed at the common good among the national government, state authorities, and local entities. A defining characteristic of India's financial structure is the predominant authority the center holds in taxation, while states, despite possessing some degree of administrative autonomy, are inherently subordinate to the central government.

Alternatively, one could argue that states deserve participation in all taxes levied by the center, with the notable exception of certain taxes. This perspective posits that the central government is obliged to share its tax revenues with state governments, indicating a financial dependency of the latter on the former. The evolving fiscal relationship is particularly noteworthy since 2015, a year marked by significant transformations. Notable developments include the establishment of the Niti Aayog in place of the Planning Commission in January 2015, the 14th Finance Commission's recommendations for substantial tax devolution, the introduction of the Goods and Services Tax (GST) framework, and the formation of the GST Council. Each of these elements has had a profound impact on the financial system of India, shaping the fiscal interplay between the central and state governments.

Pylee[7] noted that the Constitution of India uniquely outlines comprehensive provisions concerning the financial relationship between the Union and the States, which is not paralleled by any other federal

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[7] Pylee, M. (2017). *India's Constitution*. New Delhi, India: S. Chand Publishing.

constitution. One significant feature is the establishment of the Finance Commission, designed to manage the allocation and adjustment of revenues from specific sources. This aspect represents a noteworthy contribution to the complex realm of federal fiscal relations. Article 246, in conjunction with the 7th schedule of the Constitution of India, delineates a wide range of legislative powers assigned to both the central and state governments. Under List 1, the Union is empowered to enact laws related to various sectors, including taxation, specifically from entries 82 to 96. In contrast, List 2 grants states the authority to levy taxes, particularly from entries 45 to 63, although this authority is more constrained. The third list, known as the concurrent list, does not include any tax provisions. Additionally, the financial relationship between the center and the states is articulated in detail through Articles 268 to 293 in Part 12 of the Constitution. The distribution and assignment of taxes can be broadly categorized under three fundamental principles:

- Taxes are to be imposed by the central government; however, the responsibility for their collection and allocation lies with the states. This framework is specifically articulated in Article 268 of the Indian Constitution, which stipulates that duties are to be levied by the union, yet the states are tasked with the collection of these duties. Importantly, the revenue collected by the states does not contribute to the consolidated fund of India. Consequently, states retain complete authority over the expenditure of the revenue they generate through these collections.
- The framework for taxation in India delineates a system where certain taxes are levied at the central level but are designated for the states. This allocation method is articulated in Articles 269 and 269A of the Indian Constitution. Specifically, Article 269 addresses taxes imposed on inter-state transactions, which pertain to the sale or transfer of goods across state lines, with exceptions outlined in Article 269A, notably for specific goods and newspapers. Taxes collected by the central government under this structure are intended to be allocated among the states, thereby ensuring that these revenues do not contribute to the consolidated fund of India. Instead, these funds are assigned to the state where the goods were last consumed, reflecting the interest of intra-state trade and commerce. Furthermore, Article 269A clarifies that revenue generated from the Integrated Goods and Services Tax (IGST) by the central government is also subject to distribution between the central and state governments, with the share allocated to the states being excluded from the consolidated fund of India.
- The system of taxation in India encompasses levies that are established and collected by the central government, yet are allocated among the individual states. This framework is articulated

in Article 270 of the Indian Constitution, which outlines the process determined by the President of India, based on the recommendations from the Finance Commission, regarding the allocation of tax revenues generated, which are classified as Central Taxes. The scope of Article 270 includes various tax types such as income tax, excise duties on non-GST items, basic customs duties, and any other taxes not addressed in Articles 268, 269, or 269A, along with specific surcharges and cesses implemented for designated purposes. The introduction of the Goods and Services Tax (GST) brought amendments to this Article, adding two additional sub-clauses—sub-section 270(1A) and sub-section 270(1B)—which specifically outline the distribution of taxes derived from provisions under Article 246A (1) and (2), namely the Central Goods and Services Tax (CGST), Integrated Goods and Services Tax (IGST), and State Goods and Services Tax (SGST), between the central and state authorities.

The union can withdraw from the system and allocate revenue from surcharges under Article 271. Parliament has the exclusive right to levy duties or conduct searches unrelated to GST services, with net revenue flowing into India's consolidated fund. The court's interpretation of "whenever" in the Article allows the government to impose additional charges as needed.[8] This means that establishing a surcharge does not prevent the introduction of new surcharges to meet changing demands. Additionally, states needing financial aid can request grants-in-aid from both central and state governments. Article 275 outlines statutory grants based on state needs, while Article 282 addresses discretionary grants, which are given at the central authority's discretion. Statutory grants for development or welfare programs are funded by the consolidated fund, subject to finance commission recommendations. In contrast, discretionary grants do not have mandatory requirements. These tax and grant mechanisms create the financial relations framework aimed at improving India's public finance system through state collaboration.

3.2 HORIZONTAL IMBALANCES

Since the 1990s, finance commissions (FCs) have evolved substantially, becoming instrumental in compelling governments to implement economic reforms as part of broader developmental agendas.

[8] *Ved Vyas Chawla v. The Income Tax Officer,* AIR 1965 All 37.

This shift has intensified with the replacement of the Planning Commission by the NITI Aayog, which has significantly curtailed the strategic policymaking capacity of the government. Consequently, this dependence on the finance commission has led to pronounced regional and sub-regional disparities. The resultant effect has been a troubling rise in horizontal imbalances, stemming from states achieving varying levels of success, reflective of their differing growth rates and developmental statuses concerning social or infrastructural capital. Furthermore, the Terms of Reference (TOR) for the fifteenth Finance Commission have only served to exacerbate this scenario. If these TOR recommendations are enacted alongside proposed reviews from the Fiscal Responsibility and Budget Management Bill (FRBM), they risk undermining the ability of states to engage effectively in both economic and social interventions. Additionally, a "divided" revenue-sharing framework exemplifies the dynamics of fiscal governance between the central government and the states. The flow of financial resources from the union to the states occurs through a variety of channels, which can be classified into two primary categories:

- Transfers are allocated for general purposes; for instance, states may utilize these resources to address their individual requirements, which may be delineated by them.
- Transfer executed on a conditional basis (for instance, the union allocates these resources contingent upon the requirement that the states employ them for particular projects and plans established by the union).

The Twelfth Financial Commission (referred to as "twelfth FC") emphasized that grants provided a more effective mechanism for achieving fiscal balance among states in comparison to tax devolution. This led to a significant increase in the proportion of total transfers characterized as grants, particularly conditional grants. Conversely, during the Thirteenth Financial Commission, there was an observable resurgence in the share of tax devolution, which further escalated in the Fourteenth Financial Commission. However, a slight modification was noted in the Fifteenth Financial Commission, where approximately 40% of the overall transfers still pertained to conditional transfers, primarily associated with Centrally Sponsored Schemes (termed "CSS"). It is imperative to note that transfers conducted under the CSS fall outside the purview of the Finance Commission. These transfers are utilized by the central government to enhance developmental outcomes in designated sectors, predominantly in economic and social services. Given this institutional context, the Finance Commission's function concerning conditional transfers is ambiguous, particularly when the associated transactions do not reside within its jurisdiction.

On one hand, it may appear accurate to interpret "measurable performance-based incentives" as an effort to integrate contingency-driven transfers into the framework of the Finance Commission. However, this raises two pertinent issues: first, the availability of fiscal space within the Finance Commission for the creation of conditional grants post tax devolution; second, the appeal and effectiveness of such grants. This scenario necessitates a thorough examination of the contingent transfers allocated by the Finance Commission, their overall significance within total transfers, the structure of conditional transfers, and their impact on state expenditure and service delivery outcomes. If a substantial segment of Finance Commission transfers is earmarked for conditional grants, this would fundamentally alter the dynamics of fund distribution to the states. Moreover, the prioritization of resources via grants could subsequently constrain the flexibility and autonomy of states in determining their priorities. The bulk allocation of conditional grants by the Finance Commission might ultimately transform the fiscal behavior of states, posing a potential adverse impact as it suggests an encroachment on the authority of democratically elected governments to fulfill electoral commitments relating to welfare entitlements, food security, subsidies, and similar provisions. Such an intrusion undermines the foundation of representative governance. Furthermore, it has exacerbated inequitable practices, as evidenced by the incentivization of central flagship programs while simultaneously imposing constraints on state-level initiatives by categorizing them as regressive, as noted in paragraph 7(viii) of the Terms of Reference (TOR). This approach contradicts the spirit of federalism and fails to uphold the Directive Principles of State Policy (DPSP) mandated by the Indian Constitution. Additionally, the seventh clause of the TOR mandates the Fifteenth Financial Commission to assess and monitor the performance of Goods and Services Tax (GST) implementation and other governance indicators. This expanded role of the Finance Commission as a monitoring entity of state performance is in tension with its constitutionally defined responsibilities.

3.3 VERTICAL IMBALANCE

The implementation of the Goods and Services Tax (GST) serves as a significant case study in the functioning of cooperative federalism; however, it raises questions regarding its alignment with practical governance. Article 279A of the Constitution grants states a dominant 66% of voting rights in the GST Council, while the central government holds 33%. Despite this apparent distribution of power, the requirement of a three-fourths majority for passing resolutions effectively grants the central government a veto over state initiatives, even when these are proposed collectively by the states. Ideally, states should possess the authority to amend their tax structures independently, as their governance varies significantly based on local laws.

The distribution of GST revenues also incites critical analysis. The Committee on Revenue Neutral Rates proposed a split that allocated 60% to the union and 40% to the states, despite states contributing approximately 44% of their own tax revenue to GST, in contrast to the union's 28%. Additionally, the central government retains the authority to impose extra excise duties on specific goods, such as tobacco, which remains untaxed under the GST framework. Conversely, states lack the ability to levy similar additional taxes, consequently diminishing their primary source of revenue derived from indirect taxes. This situation undermines the state governments' ability to fulfill their obligations regarding taxation.

A pertinent case study underscores the necessity for fiscal autonomy and economic liberty for state governments, enhancing their governance capacity and fostering regional economic and social development. In 1982, the Chief Minister of Tamil Nadu aimed to expand the midday meal program to 7 million children in government schools to boost student enrollment. Faced with funding inadequacies, the state government opted to impose an additional tax on goods sold in Tamil Nadu. This initiative, supported by the political party in power, culminated in a significant rise in the literacy rate, achieving 83% compared to only 54% prior to the implementation of the program. This case illustrates the profound impact of fiscal independence on public policy outcomes within the states.

4. FISCAL FEDERALISM IN UNITED STATES OF AMERICA- A COMPARATIVE APPROACH

The federalist structure of governance in the United States encompasses federal, state, and local governments, each playing a distinctive role within the political landscape. Compared to many other nations, sub-national governments exert a significantly greater influence on American political life. This is a reflection of the country's historical commitment to participatory democracy and a system of checks and balances regarding governmental authority. The tax system in the U.S. is decentralized; each level of governance—federal, state, and local—operates its own tax agencies responsible for the collection of taxes within its jurisdiction. This decentralization grants substantial financial independence and authority over tax bases and rates to each governmental unit.[9] Nevertheless, it can also lead to increased compliance burdens for taxpayers and greater administrative costs for tax authorities.

State and local governments traditionally provide essential public goods and services, including both primary and secondary education, as well as police and fire protection at the local level. At the state level, they also oversee transportation, public works, social services, and higher education. Conversely, the federal government typically manages public safety and welfare programs. In recent years, state governments have assumed a more prominent role in financing public education, although the delivery of these services largely remains under local governance. Meanwhile, the federal government has expanded its involvement in funding various public sectors, particularly in social welfare and infrastructure projects; however, the implementation of these services still largely falls to the states.

The U.S. Constitution bestows both federal and state governments with autonomous taxing authority, while local governments derive their taxing powers from state legislation. As a result, each government entity imposes its own taxes, creating a framework devoid of uniform taxes, while multiple levels of government may operate on overlapping revenue streams. There is considerable diversity across states regarding tax structures; most states impose individual income taxes, corporate taxes, and sales taxes. Currently, 43 states enforce broad-based individual income taxes, while 44 states impose corporate income taxes.[10] Sales taxes are enacted by 45 states. Locally, property taxes remain the predominant source of tax revenue, although their significance has waned in recent times. Local jurisdictions may independently assess property taxes, resulting in variations in tax rates based on local taxable property definitions. Additionally, certain states permit local governments to levy sales and income taxes.

Intergovernmental transfers create a complex network of financial exchanges among different levels of government. State and local governments heavily depend on federal transfers to fulfill their fiscal obligations, with a significant portion of federal grants being channeled from state to local governments. State governments also allocate their own grants to local entities, who are heavily reliant on this funding. In the U.S., grant programs can be classified as either non-restrictive or conditional. The primary non-restrictive program historically has been revenue sharing, which is based on equity principles.

[9] Prashanth, V. (2022). A Constitutional Comparative Analysis of Taxation in the USA and India. Part 2 Indian J. Integrated Rsch. L.

[10] Nikolov, P. & Pasimeni, P. (2022). Fiscal Stabilization in the United States: Lessons for Monetary Unions. ncbi.nlm.nih.gov

Conditional grants come in two forms: block grants, which apply to broad categories and impose few restrictions on asset allocation, and categorical grants, which allocate funds for specific programs with stringent requirements.[11]

In contrast to other developed countries, the U.S. lacks broad-purpose grants intended to promote equity among states. While categorical grants do incorporate adjustment factors in their distribution formulas, they primarily serve as tools for the federal government to establish minimum standards across various sectors.

5. CONCLUSION

In a framework of cooperative federalism, it is crucial to establish mechanisms that allow for greater devolution to state governments, facilitating their financial involvement in achieving the goals outlined in the New India-2022 public development program, which emphasizes objectives pertinent to the State List. It is imperative that all levels of government are financially empowered to meet specific state goals related to fiscal deficits rather than taking a broad perspective. Future legislation from the Central Government concerning states should include more provisions for cost-sharing to assist them in fulfilling their responsibilities. Recent reforms suggest that India may have diverged from the principles of cooperative federalism. There is hope that these changes will highlight the need for a structure governing non-Financial Commission (FC) grants. With the dissolution of the Planning Commission, clearer guidelines are necessary regarding the management of grants outside its scope. States need to meet their promises, which could help them maintain their legitimacy; otherwise, this shortfall could adversely affect the principles of financial federalism, as well as broader social and economic conditions. In this context, it is essential to examine the distinctions between direct and indirect taxes, especially following the implementation of the Goods and Services Tax (GST).

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