



## *POLICY SERIES*

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# The Sharing Economy

A story of creative destruction and the erosion of barriers to entry

**BY LEE HARDING AND GERARD LUCYSHYN**



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## EXECUTIVE SUMMARY

It was a most unusual funeral. On April 29, 2017, 20 people walked mournfully through Toronto's Kensington neighbourhood. Incense wafted from the front of the procession, followed by a saxophone player and a traditional drummer. Behind them two people carried a mock casket. People followed with protest signs. Who was the object of their mourning? Actually, it was no person at all. The ceremony was a "Requiem for Rental Housing." And, according to these protesters, the neighbourhood's long-term rentals did not die a natural death. They were murdered. And the killer was the short-term rental company, Airbnb.<sup>1</sup>

It was not the first time Toronto has witnessed a public demonstration against the "sharing economy," nor was it the most dramatic. In December 2015, Toronto cab drivers took to the streets to protest Uber, the largest ride-sharing company in the world. They slowed down traffic at major access points and blocked an ambulance. One cab driver banged on the window of an Uber driver and held onto the car door handle as the car sped off, dragging him away from city hall. The man had driven cab for 22 years and even compared Uber to the terrorist group ISIS. One of his colleagues claimed half of his taxi business had been lost to Uber.<sup>2</sup>

The sharing economy, illustrated by Uber, has challenged the status quo in far more places than Toronto. Over the past decade, Airbnb and Uber have spread around the world and created new ways for people to offer services and utilize their personal capital resources to make money. Consumers have recognized the value of such services as shown by their willingness to pay for them. However, the loud outcry from those threatened by such changes has often found the ears and minds of our policy makers. This should not necessarily be the case. Every innovation that advances a country's economy will also threaten another part of it. This reality, called "creative destruction," has been acknowledged for a long time. It is the unavoidable price of advancement, where something is left behind when something better is embraced. One day, Uber and Airbnb may be on the losing end of this process themselves.

The question is should we use public policy to prevent creative destruction and protect ourselves from innovation and advancement? Of course not!

## NO GAIN WITHOUT PAIN

Uber and Airbnb have much more in common than being a popular target for protests and mock funerals. They are also in that stream of the sharing economy known as the “gig economy” that is noted for the intensified use of personally-owned capital resources. They both started at roughly the same time and in the same city, San Francisco. Airbnb started in 2008 to allow people to rent out part or all of their homes for short-term accommodations.<sup>3</sup> Uber began in 2009<sup>4</sup> to allow people without a taxi license offer rides, and to get paid, in their own vehicle. Both companies have experienced remarkable growth. Uber now operates in 633 cities in 82 countries and is valued at \$50B U.S.<sup>5</sup> Airbnb currently boasts 4 million listings in 65,000 cities and 191 countries. Guest arrivals have already surpassed 260 million rooms rented.<sup>6</sup>

Until the advent of Uber in 2009, calling a cab was nearly the only way to get a personal ride from point A to B in cities without owning a car or renting one. The launch of Uber created a rift between the new supplier and the traditional suppliers, particularly cab drivers. Licenses were restricted by governments so that cabbies would be kept busy and their businesses profitable. This restriction, or barrier to entry, for example, was acknowledged by the Vancouver Taxi Association on March 9, 2017. The association called on the province to cap the number of ride-sharing vehicles.

The problem is that there are not enough cabs, because the Vancouver Taxi Association has been denied additional licenses to meet the demand ... The Vancouver taxi companies are not insisting on a monopoly...But the reason why the number of taxi licenses has been restricted historically has been to prevent destructive competition. That rationale still applies. If there is no restriction on the number of licenses, there will be a free-for-all that will result in a situation where no one can make a living.<sup>9</sup>

Figure 1

### U.S. Newly Created Airbnb Listings (2009-2016)<sup>7</sup>

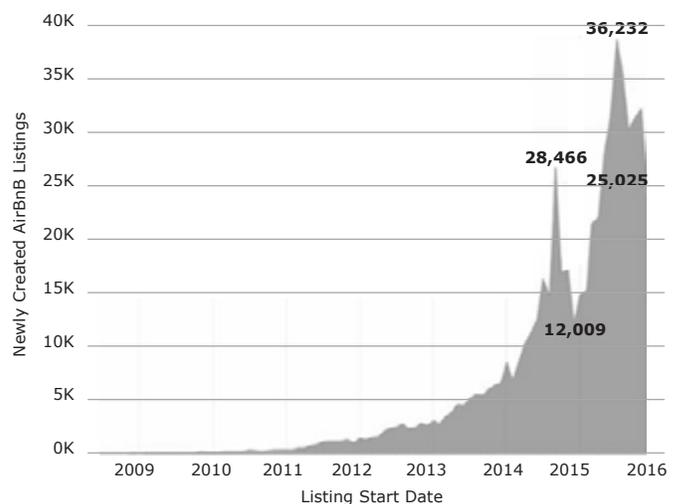
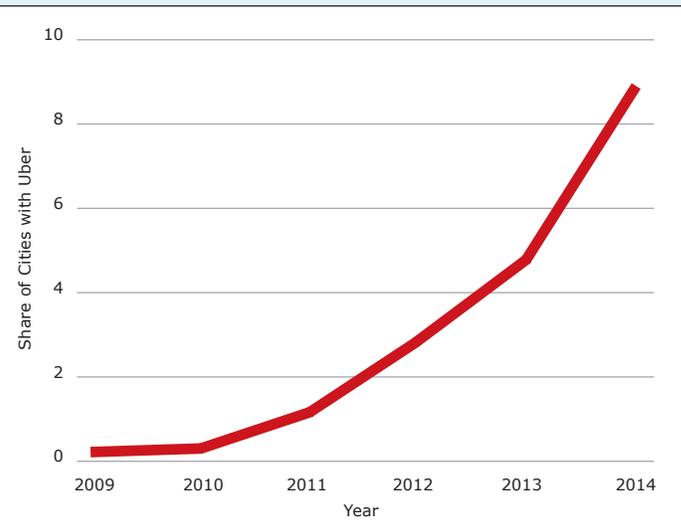


Figure 2

### Share of 50 largest metropolitan statistical areas where Uber is present (2009-2015)<sup>8</sup>



Note: By 2014 close to all 50 metropolitan statistical areas had Uber.

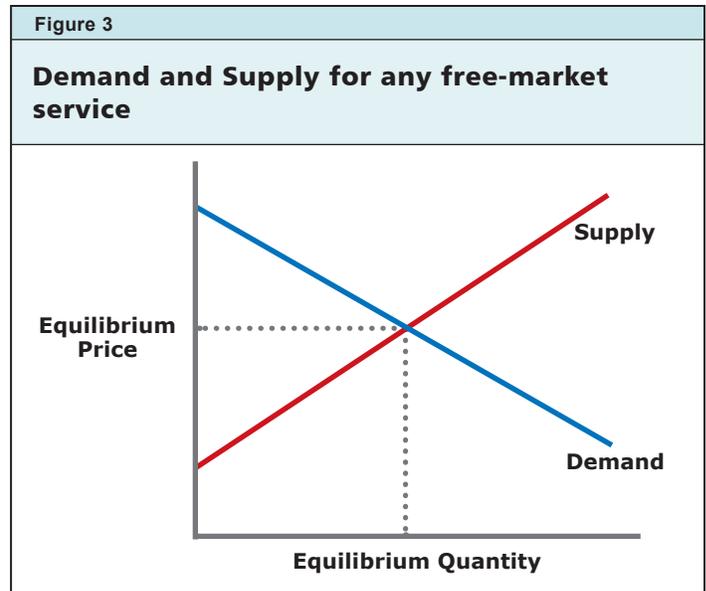
The concept of supply management is not new for Canada, including Vancouver and many other Canadian cities. In fact, most of cities have experienced the creative destruction process before, especially in the taxi cab business, case in point is The Canadian Taxi Wars between 1925-1950. This 25-year war decreased the fares and incomes of drivers after the barriers-to-enter into the taxi business were relaxed. By the 1920's the Canadian cab industry began to experience an innovative transition. The "old-line" cab companies who had substantial investments in specially-built cabs, telephone switchboards, garages, taximeters, and required municipal, hotel, and railway concessions were being challenged by newer owner operators. The old ways of doing business were being challenged by newer owner-operators using stock five-passenger automobiles instead of special-built seven-passenger sedans used by the "old-line" companies. In addition, the newer owner-operators did not pay parking concessions to hotels and railway stations to wait for customers, rather the new-owner operators began parking on the public street. Customer's seeking a cheaper taxi would simply seek them them out. Regular standard cars and no parking concessions allowed the newer owner-operators to enter the taxi market and offer a less expensive alternative service.

The last transformation of the industry came with the introduction of taxi brokers, booking services similar to modern reception centres. With taxi brokers, the newer owner-operators did not have to maintain a switchboard and simply took dispatches from a central operator. Taxi brokers would eventually offer owners-operators access to corporate advertising and garages. Many Taxi brokers did not own any vehicles. The end result cost of entry into the taxi industry had substantially decreased and the number of cabs soared. Between 1924 and 1929, for example, the number of cabs nearly doubled to 414 in Winnipeg and 1,313 in Toronto. This increase in the number of taxicabs forced the "old-line" cab companies who could not compete due to high costs falter and close. Competition drove cab fares down to the level of public transit fares, making a taxicab ride affordable for more commuters.<sup>10</sup>

As prices continued to plummet with the influx of new owner-operator taxi cabs, those who were unable to compete would be on the losing end of the disruption and would beg for regulatory reform and protection from low-priced competition. The "old-line" companies lead the charge as they needed higher fares to survive. Close behind them were transit companies who also demanded regulations as the newer owner-operators challenged the local public transport monopolies. Both the "old-line" and transit companies viewed taxi cabs as a public utility that worked best amongst a single unified system. Cities that wished to constrain competition sought uniform fares, sealed mandatory taximeters, tougher vehicle standards, restrictions on entry into the industry, minimum wage and maximum hour regulations for drivers, and compulsory personal liability insurance. Together these measures were enough to drive out many marginal operators.<sup>11</sup> Does this sound familiar?

With increased regulations and limits, profits are able to be maintained benefitting existing drivers and companies, all at the expense of consumers. With increased regulation and limit competition profits are able to be maintained. Benefitting existing drivers and existing companies all at the expense of the consumers. Riders need to continue to endure long waits and higher prices because there are fewer taxicabs than there would be in an unregulated market. However, contrary to the taxi drivers' claim, a free market does not mean that no one can make a living. It may mean, however, that some suppliers who have higher costs than their competitors, simply cannot compete and should leave the market. The free market, in general, brings equilibrium to the market where competing companies and their workers offer service at prices agreeable to the employer, the employee, and the consumer.

Taxi drivers and companies recognize that if more drivers enter the market through ride-sharing services, such as Uber, there will be increased competition, and consequently, their salaries and the value of their taxi licenses will decrease.<sup>12</sup> Therefore, restriction of competition is necessary to prevent the equilibrium from occurring, increasing the prices and limiting the supply.<sup>13</sup>



Note: Quantity Demanded equals the Quantity Supplied at the equilibrium price.

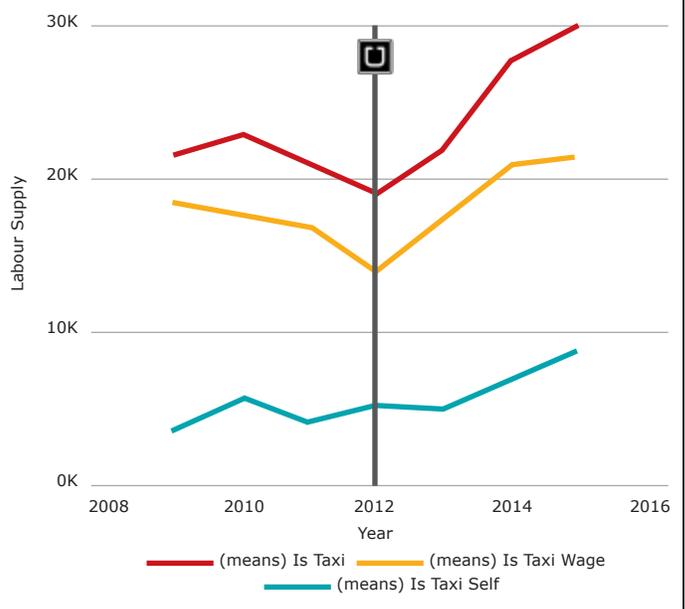
## DRIVER INCOME EFFECTS

Taxi drivers have less reason to worry about their incomes than they may have thought. An empirical study published in 2017 shows that the establishment of Uber increases the market for rides, meaning that taxis can, in fact, maintain their market share while Uber picks up the gains.<sup>14</sup> The author summarized the findings as follows:

Dr. Carl B. Frey of Oxford Martin School compared American cities with and without Uber. The results were somewhat surprising. The presence of Uber seemed to cut the income for salaried taxi drivers by about 10 per cent. Even so, self-employed cabbies actually saw their incomes increase by 10%. Meanwhile, the number of self-employed drivers increased by 50%. Uber drivers earned more per hour than their counterparts in taxis, likely Uber is more efficient at getting a driver to connect with a passenger. This means a greater percentage of the driver's time is spent with rider inside and the meter running.<sup>15</sup>

Figure 4

### Taxi employment before and after Uber - Los Angeles<sup>16</sup>



Note: Uber's introduction is denoted by a vertical solid line. The solid line represents the total labor supply for taxi drivers with wage-employed drivers represented by the short-dashed line and self-employed drivers with the long-dashed line.

Figure 5

### Taxi employment before and after Uber - New York<sup>17</sup>

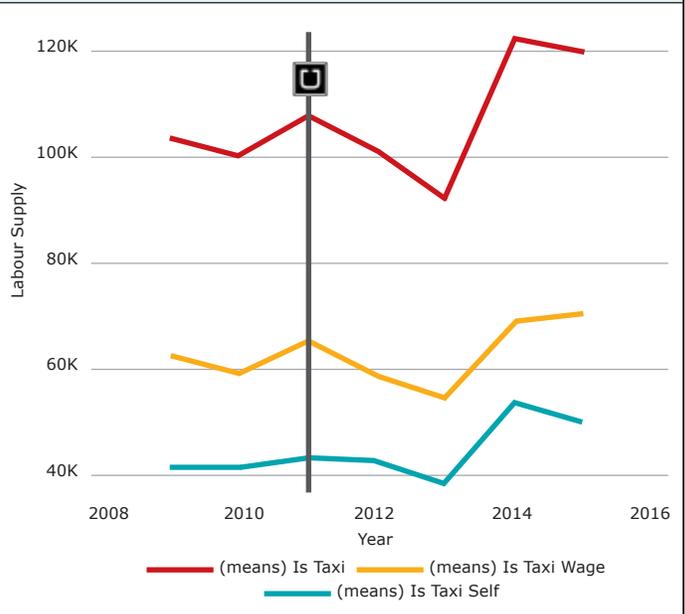


Figure 6

**Taxi employment before and after Uber - San Francisco<sup>18</sup>**

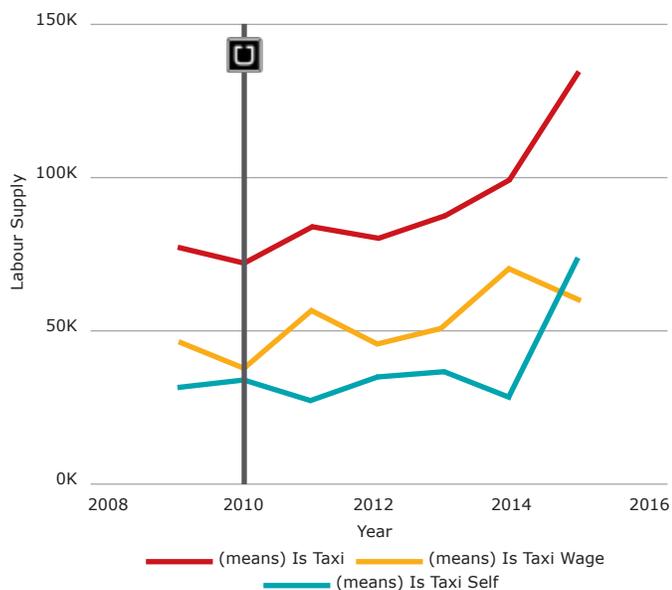
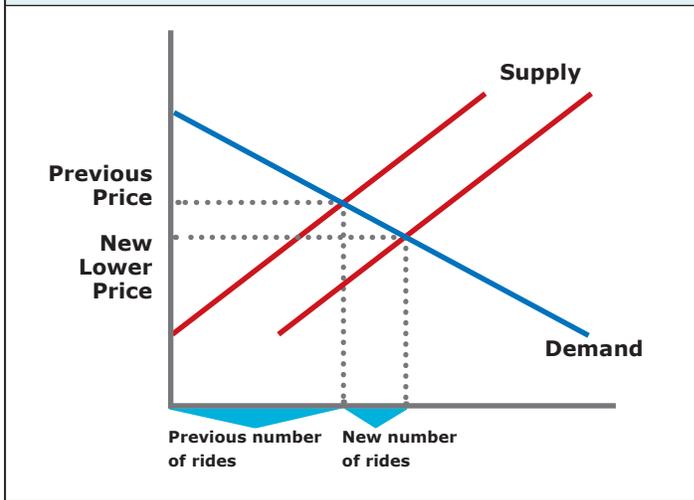


Figure 7

**Increase in Supply and Demand within a Market**



Note: An increase in the number of suppliers causes lower prices which creates more demand.

## DRIVER SLAVERY OR IMPROVED SERVICE

In 2015, Hall and Krueger demonstrated that the “free-for-all” driver-slavery scenario envisioned by the Vancouver Taxi Association does not take place. They compared the median wages of Uber drivers to taxi drivers in 18 cities in the United States. In 16 of the cities, the Uber driver made more money. The gap between the average Uber driver, at \$19.19 per hour, and the average taxi driver and chauffeur, at \$12.90, was almost \$6.29, or almost 50 percent higher. Although it is possible Uber drivers cover more expenses, the authors did not envision that it would exceed that gap, meaning that Uber drivers were paid more.<sup>19</sup> Also, the sharing economy employs a much younger demographic than the workforce at large, meaning it is more likely to capture people just entering the business than it is likely to displace those already in it.<sup>20</sup>

The growth of both Uber and Airbnb did not occur in North America during an era of widespread creative destruction, nor did it destroy efficient businesses. The fact that the impressive gains in these two industries followed the 2008 financial crisis makes that accomplishment even more profound.

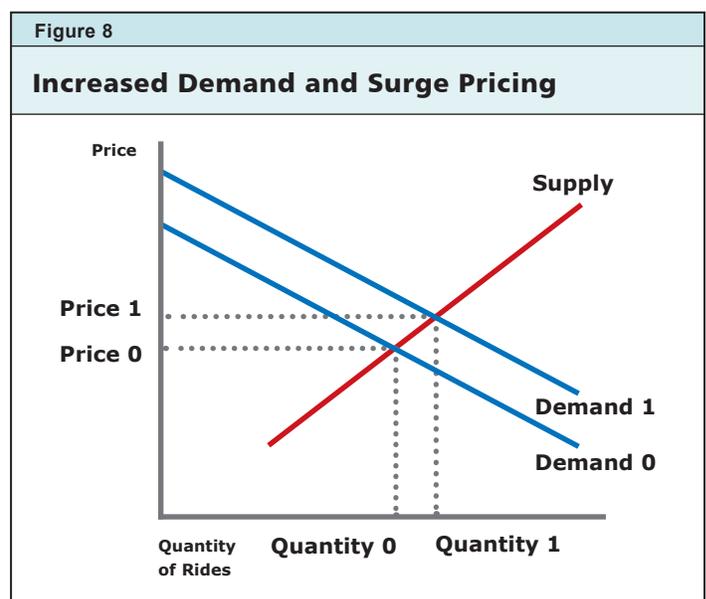
Caballero and Hammour analyzed the job market in the early 1970s to 2001. Their results were surprising. The authors found that job restructuring occurs less during recessions than in times of normal or accelerated growth.<sup>21</sup>

## Economic Effects

Does this mean that Uber and Airbnb captured more of the market during a time of economic growth? Generally, cost minimization measures tend to appear during economic downturns and not during periods of growth. That is exactly what the sharing economy does, according to Juliet Schor:

Sharing economy sites are generally lower in cost than market alternatives. Particularly with P2P [person-to-person] sites, value can be redistributed across the supply chain to producers and consumers and away from “middlemen,” in part because producers’ costs are lower. An Airbnb host, for example, can deliver a room more cheaply than a hotel. The platforms’ fees are also lower than what established businesses extract in profits. (Airbnb’s maximum fee is 15%.)<sup>22</sup>

In times of low demand, the empirical research shows that Uber offers rides at prices up to 30 percent lower than cab fares. However, at times of peak demand, its surge pricing algorithm raises prices. This counterbalances high demand to ensure customers are accommodated with the shortest possible wait times, while drivers and owners maximizing profits.



Note: As the demand for rides surges, prices rise. This provides more incentive for drivers to become active, increasing the quantity of rides supplied to match the quantity of rides being temporarily demanded at higher prices.

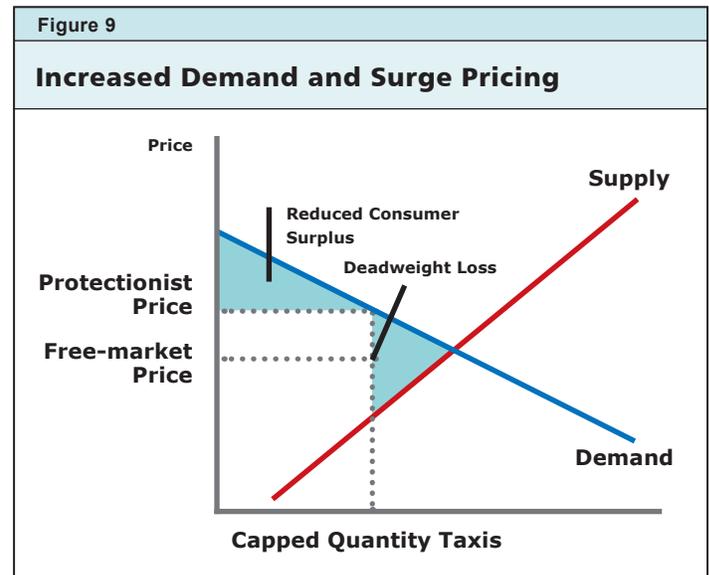
## PROTECTIONISM, PURE AND SIMPLE

It is not unusual for those who are threatened by change to try to persuade policy makers to erect barriers to entry and prohibit what they see as new competition. New competition brings disruption to the industry. So naturally, the existing companies will seek regulations and protection. This explains why, despite the clear benefits, both Uber and Airbnb have had to face numerous hurdles. Seoul, Berlin, Hamburg,<sup>23</sup> and Austin, Texas, for example, have banned Uber outright. Even where Uber has been allowed to do business, it has often faced excessive regulations. Edmonton was the first city in Canada to officially sanction Uber. The City spent \$1.5 M during Uber's first year to enforce their regulations for ride-sharing services. 278 tickets for violating the regulations were issued to Uber drivers, all of them were dismissed. No doubt, the United Cabbies Association of Edmonton, "Stop Uber for Public Safety", campaign helped inspire this legal persecution, despite seemingly having little basis.<sup>24</sup>

Government protectionism, as regulatory policies, often shields local businesses from competition by increasing the policies, taxes, and discouraging competition. Such measures, of course, have the same consequence, whether implemented locally or nationally, resulting in an increase in prices paid by consumers to suppliers whose costs are higher than the competitors the government discriminates against. This type of protectionism is usually defended because it protects jobs and wages for the people already in the shielded industry. However, if the consumer was really interested in paying higher prices to suppliers to ensure that the supplier was "making enough," they would simply tip the driver more for the service they receive.

Basic economic theory shows that whenever supply of the equilibrium quantity of a service is limited, the price for that service increases more than in a free-market. This means that there will be a reduction in the consumers' surplus, which is the consumer benefit measured by the difference between the

amount the consumer is willing to pay and the actual amount they paid. The reduction in consumers' benefits is due to an increase in inefficient producers' welfare (producers' surplus). The lost economic efficiency is due to the market distortion known as a deadweight loss. In the case of ridesharing regulation, this means consumers pay higher prices and the availability of ride services is reduced to protect high-cost suppliers.



Note: The protectionist price is greater than the free-market price when the number of taxi cabs are limited there is greater demand than supply at higher prices. The supply restriction causes a deadweight loss.

The Canadian taxi and limousine service industry is comprised of approximately 18,725 businesses that divide up nearly \$2.7B in revenues, paying out \$1.2B in wages. Due to a variety of operating regulatory regimes across the country, the industry's growth and profitability are affected by consumer spending, corporate profits, inbound international travel, the price of oil, and new vehicle sales.<sup>25</sup> To understand the extent of local industries one can review the taxi cab industry in a few Canadian cities. For instance, Calgary has a population of approximately 1.4 million being served by 1,411 taxi cabs, approximately one taxi for every 1,000 people.<sup>26</sup> Edmonton has approximately 1.3 million people, served by 1,319 taxis, again approximately one taxi for every 1,000 people.<sup>27</sup> Toronto has a population of about 2.8 million people and 4,849 licensed taxicabs, which results of approximately 1.73 taxis for every 1,000

people. It is worth noting, that Toronto's taxis are licensed to only 2,422 people. Toronto's taxicabs delivered approximately 21.5 million fares per year.<sup>28</sup> Close to 780,000 people reside in Winnipeg and are serviced by 750 taxi licenses, which is approximately 0.96 taxis per 1,000 people. In 2015, Winnipeg's taxicabs delivered close to 3.13 million fares.<sup>29</sup> These numbers indicate that, on average, more than 4,000 trips are made per taxi license annually. Since these licenses are usually owned by only a few companies, these companies have a large financial incentive to lobby government to restrict ride-sharing companies, like Uber, from entering the market and undercutting taxi companies.

The hospitality industry is no different. Airbnb has succeeded in operating in more jurisdictions than Uber, but its capacity has often been restricted, thanks to groups such as Fairbnb. Many cities have restricted Airbnb rentals to a certain number of calendar days annually or only to bedrooms in the primary suite of the host, thereby banning secondary suites or independent units. These restrictions only comprise 5.5 percent of the listings in the United States in 2015, although a few of these cities had already introduced such restrictions. Of these 19,800 Airbnb listings represent only 0.003 percent of total homes — a negligible impact on general housing availability.<sup>30</sup>

Figure 10

**Days that Airbnb locations were available for rent (top) and rented (bottom). (USA, 2015)<sup>31</sup>**

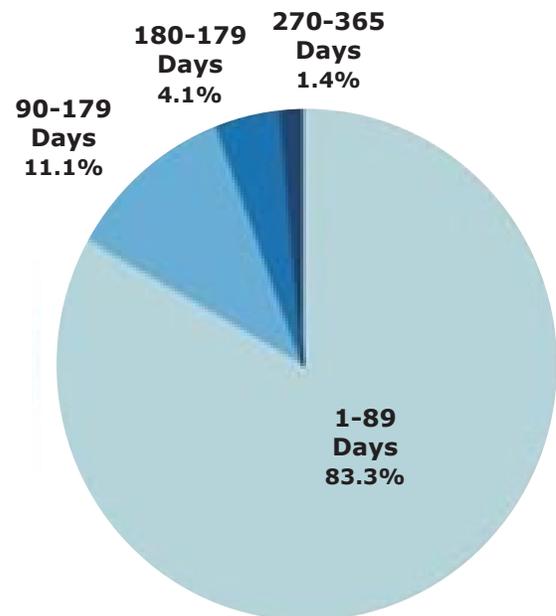
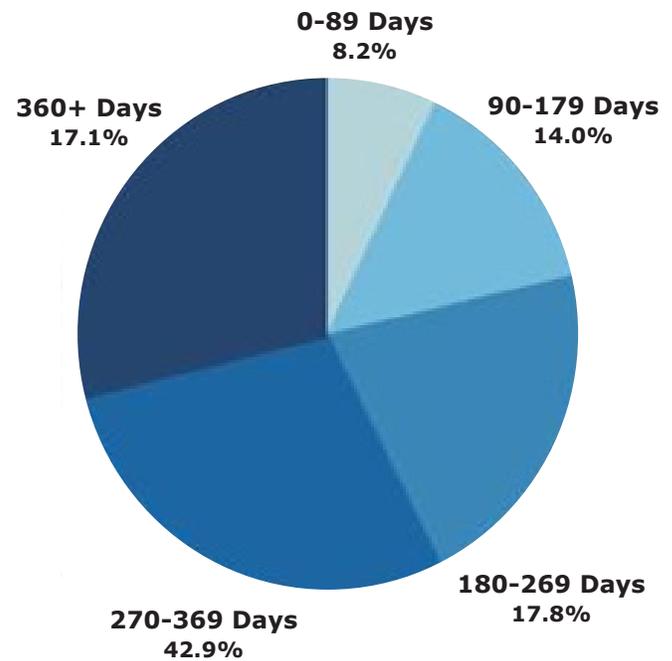
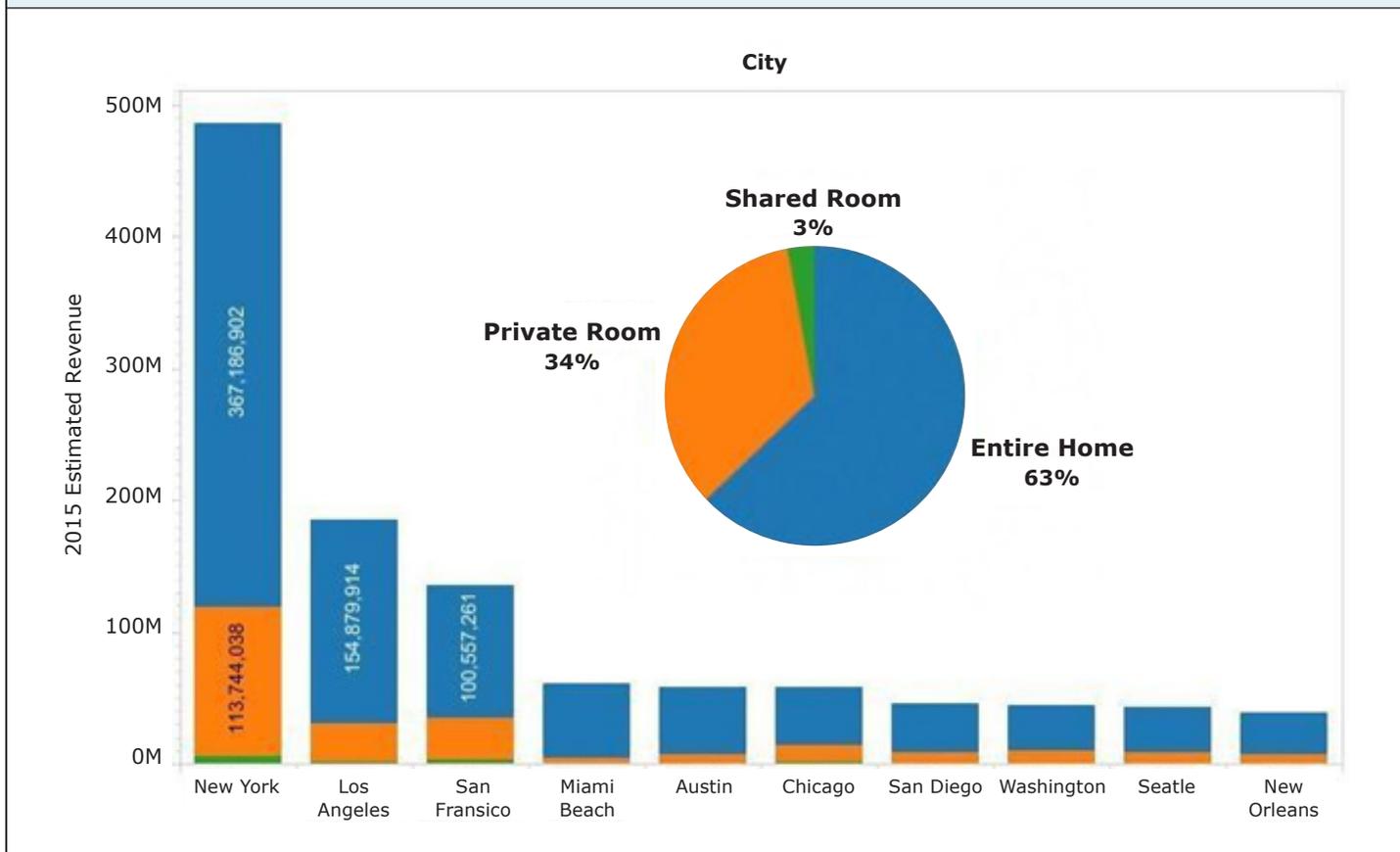


Figure 11

Percentages of Airbnb accommodations and estimated revenues by city (USA, 2015)<sup>32</sup>

A ban on suites that are not in the primary residence of the owner, represents a much greater imposition. Whole suites comprise an overwhelming portion of the Airbnb revenues, a ban on Airbnb all but eliminates this revenue stream, except for times owners are away from their primary residences and rent them out.

The Canadian experience parallels the experience in the United States. An analysis by the Hotel Association of Canada shows that between April 2015 and March 2017, Airbnb listings almost doubled, with 100,500 listings making more than a half-billion dollars in revenues. Whole unit rentals comprised nearly 70 percent of these listings. About 7 percent of hosts list more than one whole unit, accounting for 19 percent of the units, and 30 percent of the revenue generated. Units that rent more than 180 days annually number at only 5 percent, but comprise 20 percent of the annual revenues.<sup>33</sup>

Figure 12

**Entire Home Rentals in Canada as a Percentage of Airbnb Activity<sup>34</sup>**

Percentage of Entire Home Rentals				Percentage of Total			
Unit Type		Hosts	Units	Revenue	Hosts	Units	Revenue
Entire Home	1	90.2%	72.8%	63.8%	66.9%	49.7%	53.2%
	2+	9.8%	27.2%	36.2%	7.3%	18.6%	30.2%
	<b>Total</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>74.2%</b>	<b>68.3%</b>	<b>83.4%</b>
<b>All Other</b>					<b>24.8%</b>	<b>31.7%</b>	<b>16.6%</b>
<b>Canada Totals*</b>					<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

If people can make more money on short-term rentals than on long-term rentals or living in the space themselves, the market should allow that to happen. Even if it does not mean a more intense use of space, it does mean a more intense use of housing capital on that space. Airbnb facilitates tourism for those who might otherwise not be able to afford it, meaning more money is spent in the neighbourhoods and cities that allow for such residency. A recent comprehensive study in 2017 by Smith Travel Research shows that across 13 global markets that Airbnb listings did not affect hotel demand and revenues. However, a study conducted in Texas by Zervas, Proserpio, and Byers demonstrated a very minor negative impact of about 0.05 percent decrease in hotel revenues for every 1 percent increase in Airbnb listings.<sup>35</sup>

Similarly, the impressive rise of Airbnb in Canada does not seem to have affected hotel accommodation. Airbnb unit listings have almost doubled annually over the last few years, whereas hotel room capacity has also risen at a very steady rate of about one percent per year. Hotel rooms still outnumber Airbnb units at a rate of 6.5 to 1. The Hotel Association of Canada estimates that in 2016, hotel guests contributed roughly \$2.2B in consumer taxes and fees based solely on room revenues. Similarly, Airbnb contributed roughly \$85M in taxes and fees.<sup>36</sup>

Figure 13

### Canadian Airbnb Rental Units as a Percentage of Total Accommodation Room Inventory by City, 2016<sup>37</sup>

	Airbnb Entire Home Rentals	Total Airbnb Rentals	Hotel Room Inventory	Airbnb Entire Home Units	Airbnb Total Units	Total Hotel and Airbnb Units
Vancouver	26%	38%	23,475	9,688	14,424	37,899
Victoria	21%	27%	5,941	1,691	2,185	8,126
Calgary	10%	17%	14,213	1,803	2,962	17,175
Edmonton	5%	9%	15,626	872	1,466	7,082
Regina	2%	5%	3,720	97	183	3,988
Winnipeg	4%	8%	7,148	287	615	7,763
Toronto	21%	32%	44,312	13,913	20,875	65,187
Ottawa-Gatineau	13%	23%	11,425	1,998	3,379	4,804
Montreal	35%	48%	23,000	15,426	21,489	44,499
Quebec City	17%	25%	10,850	2,460	3,567	4,417
Halifax/Dartmouth	11%	17%	5,399	705	1,133	6,532
11 Cities Highlighted	21%	30%	165,109	48,940	72,278	237,387
TOTAL Canada	12%	18%	68,658	68,658	108,543	552,632

Figure 14

### Year-Over-Year Growth in Airbnb and Hotel Room Inventory, Canada<sup>38</sup>

#### Annual Growth in Canadian Airbnb Unit Supply

Years	Rooms	Y-O-Y-A
2015	52,130	
2016	100,543	93%

#### Y-O-Y-A In Inventory



Airbnb



Hotel

#### Annual Growth in Canadian Hotel Room Supply

Years	Rooms	Y-O-Y-A
2009	426,447	
2010	431,058	1.1%
2011	435,247	1.0%
2012	437,677	0.6%
2013	440,049	0.5%
2014	442,552	0.6%
2015	447,586	1.1%
2016	452,089	1.0%
2016	452,089	1.0%
2017F	457,963	1.3%

0.9% CAGR

Source: Airbnb, Airdna, CBRE Hotels, June 2017.

Historical precedent tells us that the outcry of cab companies over Uber or hospitality unions over Airbnb should be expected. The reasons for it are no different than the taxi wars that took place in many cities last century. Fortunately, empirical studies have demonstrated repeatedly that the disruption caused by the sharing economy is much less than the cab companies and Airbnb have claimed. Even to the extent disruptions exist, this should not sway policy makers from using regulations efficiently

for the protection of consumers. Basic economic theory tells us that protectionism only results in higher production costs, allocative inefficiency of resources and limited consumer choice all at the consumers expense. Destruction of the old only occurs as much as new businesses provide better and cheaper services. Policy makers should not fear the price of progress, but they should embrace it as the direct effect of something good being replaced by something that is better.

## PARADOX OF PROGRESS

Creative destruction represents the necessary condition to reap the benefits of innovation and capitalism: better service at a better price for consumers. Nevertheless, the Vancouver Taxi Association described an open market for rides as “destructive competition,” but a fuller perspective would see it simply as “creative destruction.” Joseph Schumpeter first defined this concept in his important 1942 work, *Capitalism, Socialism, and Democracy*:

The opening up of new markets, foreign or domestic, and the organizational development from the craft shop to such concerns as U.S. Steel illustrate the same process of industrial mutation — if I may use that biological term — that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism. It is what capitalism consists in and what every capitalist concern has got to live in.<sup>39</sup>

Protectionism, whether for cabbies or anyone else, hinders productivity. In 2004, economists for the National Bureau of Economic Research analyzed labour in 60 countries and found, “By impairing worker movements from less to more productive units, effective labour protection reduces aggregate output and slows down economic growth. We estimated that moving from the 20th to the 80th percentile for job security lowers annual productivity growth by as much as 1.7 per cent.”<sup>40</sup> As W. Michael Cox and Richard Alm have written, “The ironic point of Schumpeter’s iconic phrase is this: societies that try to reap the gain of creative destruction without the pain find themselves enduring the pain but not the gain.”<sup>41</sup> As the authors say,

Herein lies the paradox of progress. A society cannot reap the rewards of creative destruction without accepting that some individuals might be worse off, not just in the short term, but perhaps forever. At the same time, attempts to soften the harsher aspects of creative destruction by trying to preserve jobs or protect industries will lead to stagnation and decline, short-circuiting the march of progress.<sup>42</sup>

Although creative destruction may make a few suppliers victims to innovation and progress, protectionism makes all consumers victims of limited choice and higher prices.

## TODAY'S WINNERS MAY BE TOMORROW'S LOSERS

Uber and Airbnb are the latest examples of new industries that undermined older ones. Cox and Alm have qualitatively demonstrated this with examples from the United States. At the turn of the 20th century, 109,000 people made carriages or harnesses and 238,000 were blacksmiths; today such jobs are few. In 1920, 2.1 million worked for railroads, which today employ fewer than 200,000. Sawyers, masons, and miners cannot be found in the top 30 occupations today as they did in 1900, but medical technicians, engineers, and computer scientists can.<sup>43</sup> The passage of time makes clear how foolish it would have been to artificially sustain such industries by regulations. However, policy makers are still tempted to preserve old industries, as Cox and Alm explain:

Even with the higher living standards, however, the constant flux of free enterprise is not always welcome. The disruption of lost jobs and shuttered businesses is immediate, while the payoff from creative destruction comes mainly in the long term. As a result, societies will always be tempted to block the process of creative destruction, implementing policies to resist economic change.

Attempts to save jobs almost always backfire. Instead of going out of business, inefficient producers hang on, at a high cost to consumers or taxpayers. The tinkering short-circuits market signals that shift resources to emerging industries. It saps the incentives to introduce new products and production methods, leading to stagnation, layoffs, and bankruptcies.<sup>44</sup>

The inefficient producer can only be protected at the expense of the consumer who must have fewer choices and higher prices. Politicians who side with protectionism, increasing the cost to consumers and limiting the consumers choice, may discover consumers selecting the alternative at the ballot box. In a democratic capitalist society, one that believes in the principles of a free market economy, this result would be just.

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