

## Tax Policies to Encourage Women's Labor Force Participation

Sara LaLumia



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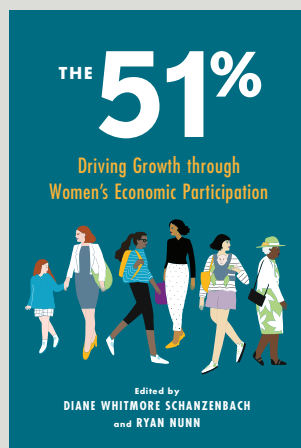


# Tax Policies to Encourage Women's Labor Force Participation

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OCTOBER 2017

A CHAPTER IN THE RECENTLY RELEASED HAMILTON PROJECT BOOK



## The 51%: Driving Growth through Women's Economic Participation

The U.S. economy will not operate at its full potential unless government and employers remove impediments to full participation by women in the labor market. The failure to address structural problems in labor markets—including tax and employment policy—does more than hold back women's careers and aspirations for a better life. In fact, barriers to participation by women also act as brakes on the national economy, stifling the economy's ability to fully apply the talents of 51 percent of the population. By acting to remove barriers to women's participation, we can realize stronger economic growth that will be more broadly shared by the American people.

# Abstract

The current tax treatment of married couples reduces wives' labor force participation and creates other inefficiencies. I propose a new second-earner deduction, equal to 15 percent of the earnings of a lower-earning spouse. The proposed deduction would raise the after-tax return to work for many wives, encouraging an increase in married women's labor supply, and would reduce marriage penalties on average.

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# Introduction

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It is well known that women earn less than men. In the first quarter of 2017, median weekly before-tax earnings for women were 80.5 percent of median weekly earnings for men (Bureau of Labor Statistics [BLS] 2017).

It is less well known that the gap between women's earnings and men's earnings would be even larger if measured in after-tax terms instead of before-tax terms. Ordinarily, the progressive income tax system acts to mitigate differences in before-tax earnings. However, the tax treatment of married couples tends to raise the tax rate faced by the spouse who is the lower earner in a couple. This group of spouses, often referred to as secondary earners, is still predominantly female.<sup>1</sup> This gender difference in the after-tax return to working is likely more important than the before-tax difference for decisions about whether to work and for household well-being. In addition to causing an inefficient distortion in the labor supply decisions of men and women, the current tax treatment of married couples lowers married women's labor force participation and impedes their labor market progress relative to men. In this paper, I propose changes in the tax treatment of married couples that would address these problems by reducing the tax penalty incurred by many married women.

Policy makers have long grappled with the challenges of designing the best possible tax system for families. There is an inherent tension between three objectives policy makers might seek in taxing the family. The first objective is progressivity, or the levying of a higher tax on families with a greater ability to pay. The second objective is equal treatment of households with equal ability to pay. The operational definition of "ability to pay" has traditionally been taxable income, which excludes the value of any nonmarket home production (e.g., caring for the family's children or preparing meals for the household). The third objective is marriage neutrality, or the idea that the amount of tax a couple pays should not depend on the couple's marital status. In other words, the tax code should avoid creating "marriage penalties," in which members of a married couple pay more filing jointly than they would filing as two unmarried individuals. My primary focus in this paper is to consider tax changes that would increase female labor force participation rates. However, I will also discuss how proposed reforms would alter the tax system's ability to tax progressively, to provide equal tax treatment of families with equal ability to pay, and to move away from a marriage tax penalty.

Since 1948 the United States has used a policy of joint taxation, taxing a married couple as a unit on the basis of the combined income of husband and wife. By making a wife's tax rate dependent on her husband's earnings, joint taxation raises wives' tax rates, on average, and reduces their labor supply. Joint taxation, in conjunction with other elements of the tax code that vary with marital status, also creates many violations of marriage neutrality. While joint taxation was once lauded as a step toward equal treatment of households with equal ability to pay—because it considers only the total income of the couple and does not account for its distribution across earners—this interpretation does not hold when the value of household nonmarket production is incorporated into measures of ability to pay (Apps and Rees 2011). For example, a household with one spouse not participating in the labor market and one full-time employee earning \$50,000 is likely better off than a household with two full-time employees each earning \$25,000. In the former case, the nonemployed spouse is typically able to generate considerably more nonmarket production that benefits the household—such as child care and home cooking—than can be provided when both spouses work.

In this paper I propose a second-earner deduction that would be added to the existing tax code. Two-earner couples would reduce their taxable income by an amount equal to 15 percent of the earnings of the lower-earning spouse. A second-earner deduction would raise the after-tax return to work for many married women, and would also reduce marriage penalties on average. It would go part of the way toward addressing concerns that households with two earners have lower effective ability to pay.

There is historical precedent for such a policy. Between 1981 and 1986 a secondary earner deduction was in place (Feldstein and Feenberg 1996). It was eliminated not because of particular concerns about the design of the deduction, but rather as part of the large set of reforms associated with the Tax Reform Act of 1986. A second-earner deduction also has the potential to garner bipartisan support. A modest second-earner tax credit was included in the last budget proposed by the Obama administration (U.S. Department of the Treasury 2016), and policies to reduce marriage penalties in the tax code have historically been championed by Republicans (Zelenak 2000). In addition to discussing these issues in my proposal, I also briefly describe some considerations related to a more radical change: a switch away from joint taxation.

# The Challenge

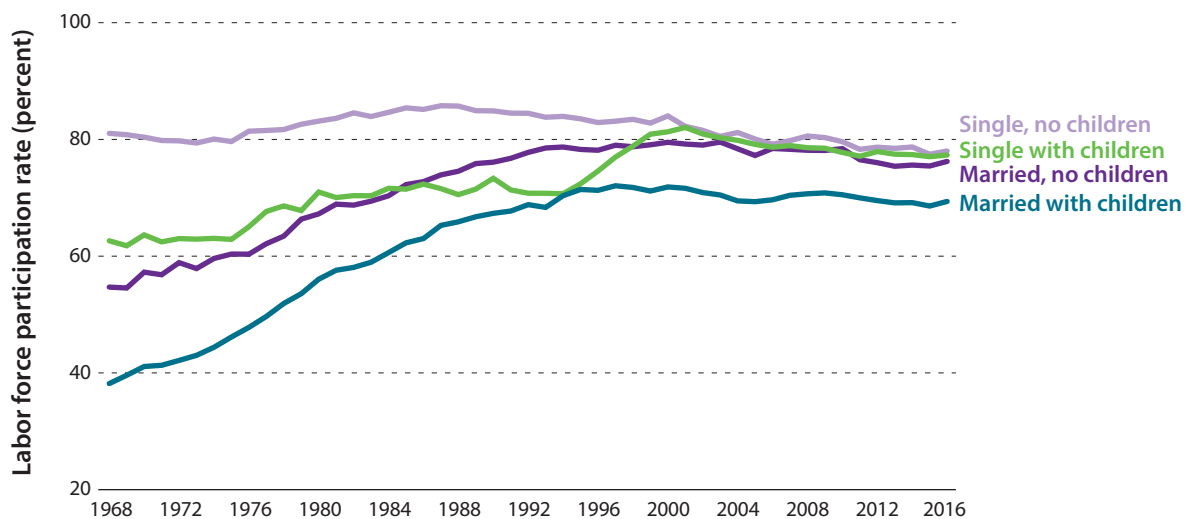
Both marriage and children affect a woman's propensity to work. Figure 1 plots nearly 50 years of labor force participation rates for married and unmarried women with and without children under 18 in the household; all the women are between the ages of 25 and 54. Throughout the entire period, married women have had lower rates of labor force participation than unmarried women. However, the size of the participation gap between groups has varied over time. From the late 1960s until the late 1980s, women's participation rates rose regardless of marital status and presence of children in the household. The rate of increase was greater for married women than for unmarried women, and by the early 1990s married women with and without children were participating at similar or higher rates than single women with children, respectively. Over the course of the 1990s, though, labor force participation of unmarried mothers rose significantly. This well-documented increase reflected a number of policy changes, notably including welfare reform and the expansion of the Earned Income Tax Credit (EITC; Meyer and Rosenbaum 2001). Since around the

year 2000, labor force participation rates have been stagnant or on a slow decline for all four groups of women. Today, the participation rate remains substantially lower for married women than for unmarried women, and the policy recommendations made in this paper are motivated by this pattern.

Under the joint taxation system currently used in the United States, the incomes of a husband and wife are pooled and then taxed using a set of tax brackets wider than the brackets for unmarried individuals. An alternative, used in a majority of developed countries, is a system of individual taxation.<sup>2</sup> Under individual taxation, a woman earning a low amount will be taxed at a low rate. Assuming a progressive rate structure, her tax rate will rise as her earnings increase. By definition, any direct effect that the tax system has on her decision to work is independent of her husband's earnings. In contrast, under joint taxation the income tax rate that a woman faces depends on her husband's earnings. Specifically, the tax rate on the first dollar of her earnings is the same as the tax rate on her husband's

FIGURE 1.

## Prime-Age Women's Labor Force Participation, by Marital Status and Presence of Children under Age 18



Source: Current Population Survey Annual Social and Economic Supplement 1968–2016.

Note: Sample includes women ages 25–54. “Married” is defined by women who have a spouse in the household or not in the household. “Single” is defined as all other women, including divorced and widowed women. “With children” is defined as having at least one child in the household under the age of 18. “No children” is defined as having no children in the household under the age of 18.



last dollar of earnings. Assuming a progressive rate structure, this pushes women—even those with limited earnings—up into higher tax brackets and likely discourages labor market participation. The policy proposals discussed here attempt to mitigate this effect, removing impediments to work for many married women.

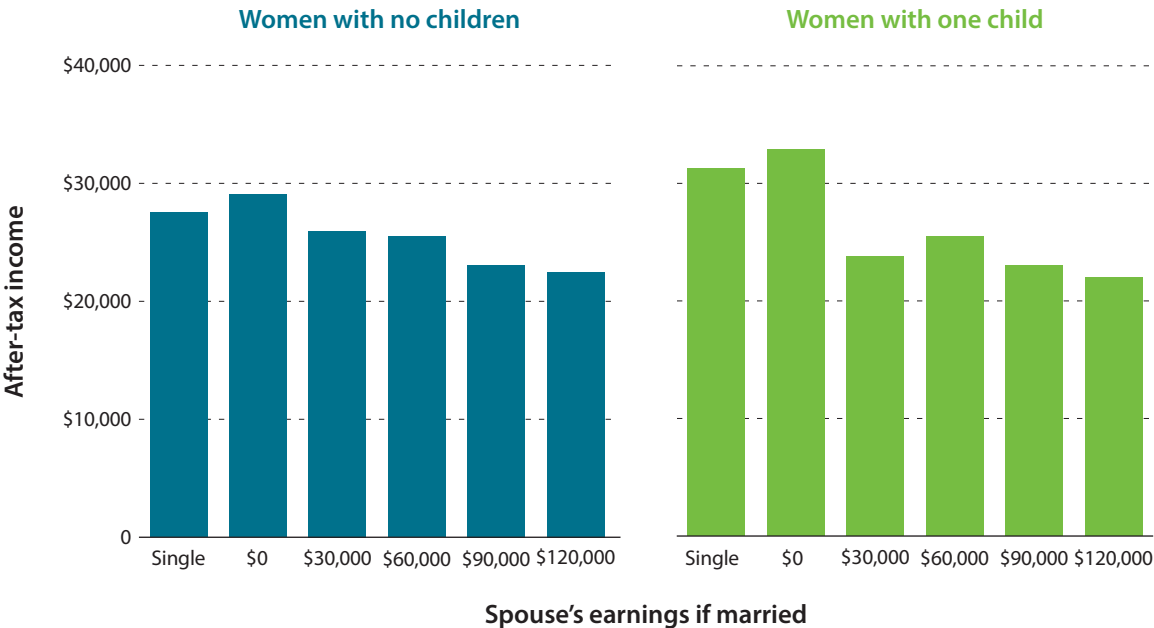
Figure 2 shows how the current tax system affects the after-tax return to working for women in various situations. For example, consider a woman who is deciding if she should take a job with before-tax pay of \$30,000. The figure shows the after-tax net income she will receive if she takes the job, depending on her marital status and, if she is married, depending on her husband's before-tax income. Importantly, the after-tax return from taking a job is lower for a woman who would become the lower earner within a married couple than for an otherwise similar single woman.

The left-hand portion of the figure shows after-tax income for a woman with no children. If she is single, taking the job will move her from being a non-filer, with no tax liability, to being a taxpayer with a filing status of single. After claiming a standard deduction and paying tax on her income, taking the job will yield an after-tax income of \$27,516. If she is married, she will use a filing status of married filing jointly, with a higher standard deduction. If her husband has no income, taking the job will yield an after-tax income of \$29,070; this has the effect of raising the after-tax return to entering the workforce. For

women who would be the sole earner in their households, the tax treatment of married couples therefore raises the after-tax return to labor market participation. But relatively few women in partnered households are sole earners.<sup>3</sup> The next bar in the figure shows that, if the woman is married to a man earning \$30,000 in before-tax income himself, taking the job nets the woman only \$25,963. As the husband's income rises, the wife's after-tax return from taking the job falls still farther.

The right-hand portion of figure 2 shows equivalent calculations for a woman with one child. The same basic pattern is evident here: marrying a man with zero earnings raises the return to taking a job, while marrying a man with significant positive earnings reduces the after-tax return to work. As in the previous case, the deterioration in work incentives is larger when the husband earns more. What is different here, relative to the childless case, is that married couples with household income near \$30,000 are receiving the EITC. This credit functions as a wage subsidy at low levels of earnings, allowing a job with before-tax pay of \$30,000 to yield an after-tax amount greater than \$30,000. The credit amount gradually increases with earnings over a phase-in range, remains constant at the maximum credit amount as earnings increase within the plateau range, and then gradually falls with earnings over the phaseout range. The phaseout of the credit creates high marginal tax rates at certain income levels, and is evident in the very large decline in the after-tax return received by a wife when her husband's earnings increase from \$0 to \$30,000.

**FIGURE 2.**  
**Women's After-Tax Income from \$30,000 Job, by Spouse's Earnings and Presence of Children**



Source: Author's calculations.  
Note: Calculations reflect 2016 tax law and do not incorporate state income or federal payroll taxes.



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# A New Approach

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## SHORT-TERM SOLUTION: SECOND-EARNER DEDUCTION

One way to increase wives' after-tax gain from entering the labor market would be to institute a tax deduction based on the earnings of a second worker in a married couple. Here I consider a deduction equal to 15 percent of the earnings of the lower-earning spouse in a married couple, up to an earnings cap of \$75,000. This corresponds to a maximum deduction of \$11,250. Married couples with two earners would be able to reduce their taxable income by the amount of the deduction, making work more attractive for second earners. The corresponding tax savings would be equal to the amount of the deduction multiplied by the couple's marginal tax rate. For example, consider the case of a wife who can take a job with before-tax earnings of \$30,000. Suppose her husband earns just over \$30,000. The wife's prospective earnings would make her household eligible for a second-earner deduction of \$4,500. This couple would be in the 15 percent tax bracket, and claiming the second-earner deduction would reduce their tax liability by 15 percent of \$4,500, or \$675. In other words, the net gain that the wife would receive from entering the work force would increase by \$675.

The proposed deduction would depend on the earnings of the lower-earning spouse within a married couple, without an explicit reference to gender, and would be available to same-sex couples who file jointly. Because wives earn less than husbands on average, the majority of couples claiming a second-earner deduction would designate the wife as the second earner. For tax year 2010, among joint returns that included wage income generated by both the husband and the wife, the wife earned less than half of the couple's combined wage income in approximately 68 percent of cases (Pierce and Gober 2013).

Like any tax deduction, the proposed second-earner deduction would be of greater benefit to families facing a higher marginal tax rate. Extending the earlier example, suppose that the wife considering a job with before-tax pay of \$30,000 is now married to a husband with earnings of \$120,000. This places the couple in the 25 percent tax bracket. In this scenario, the second-earner deduction would lower the tax liability of the couple (and raise the wife's net return from entering

the labor market) by 25 percent of the \$4,500 second-earner deduction, or \$1,125. This feature of the deduction reduces the progressivity of the tax code somewhat. On the other hand, figure 2 shows that the wives who currently face the lowest after-tax gain from entering the labor market are those married to higher-earning husbands. These wives face particularly high tax rates on their first dollar of income precisely because their husbands' earnings place them in high tax brackets. A deduction delivering greater tax savings to wives facing higher marginal tax rates mitigates this particular pattern.

The extent to which a second-earner deduction affects the overall progressivity of the tax code depends in part on how the deduction is phased out. I propose a phase-out beginning at an adjusted gross income (AGI) of \$150,000. This means that a couple in which each spouse earned \$75,000 in wage income (with no other income) would receive the maximum deduction. The deduction rate would then be reduced by one percentage point for every \$2,000 of AGI above \$150,000, so that the deduction is fully phased out for couples with AGI of \$180,000 or more. Internal Revenue Service (IRS) data from tax year 2014 show that slightly more than 10 percent of joint filers report AGI of \$200,000 or more (IRS 2014). Thus, this particular phase-out rule would make the second-earner deduction unavailable to couples in the top 10 percent of the joint filer income distribution.

The proposed deduction would be of limited benefit to the lowest-income filers. A deduction reduces the tax liability only of filers with positive taxable income. Couples with combined income less than the standard deduction plus personal exemption amounts do not have positive taxable income and would not be able to claim a second-earner deduction, and couples with positive but very low amounts of taxable income would be able to claim a second-earner deduction only as large as their taxable income.<sup>4</sup> It is worth noting that these low-income families would not see any reduction in their EITC as a result of the new second-earner deduction: the EITC benefit amount would continue to be calculated as a function of all earned income. Importantly, married couples with children who are currently in the phaseout portion of the EITC, for whom the current tax code poses a particularly strong disincentive to work, would earn enough to benefit from the proposed second-earner deduction.

Under the proposal, both wage income and earnings from self-employment would be treated as earned income for purposes of calculating the second-earner deduction.<sup>5</sup> There are two arguments for treating self-employment income in this way. First, the EITC definition of earned income includes self-employment income. Needless complexity can be avoided by using a parallel definition for a new earnings-related tax provision. Second, self-employment could be a particularly attractive form of labor market participation for women, especially mothers, who value scheduling flexibility (Lim 2016).

In addition to encouraging female labor force participation by raising the after-tax return to wives' entry into the labor market, a second-earner deduction would have implications for the pattern of marriage penalties and marriage bonuses. As of 2009, approximately 38 percent of married couples faced a marriage penalty. Marriage penalties are more common for two-earner couples than for one-earner couples, with penalties becoming more likely as the earnings of a husband and wife become more similar (Alm and Leguizamon 2015). The introduction of a second-earner deduction would reduce the share of couples experiencing a marriage penalty. Furthermore, its design would direct larger tax savings to couples who are currently most likely to pay a marriage penalty.

#### **FUTURE AGENDA: INDIVIDUAL TAXATION**

In the long run there would be advantages to switching away from joint taxation of married couples, instead taxing each individual on the basis of his or her own income regardless of marital status. Other countries—such as the United Kingdom in 1990—have switched from joint to individual taxation, and a majority of OECD nations currently use individual taxation. However, there are legal issues that would make the transition process difficult, and there are administrative issues that would present challenges even after a successful transition.

One important advantage of adopting individual taxation is that married women's labor force participation rates would very likely rise. Severing the link between a husband's income and a wife's tax rate will lower wives' tax rates, on average, and increase their net return to entering the labor market. Evidence from policy changes in a number of countries, with very different institutional contexts, consistently indicates that wives' labor supply is greater under individual taxation than under joint taxation. Such policy reforms have been studied in the cases of Canada (Crossley and Jeon 2007), the

Czech Republic (Kaliskova 2014), Sweden (Selin 2014), and the United States (LaLumia 2008). A second advantage would be that individual taxation would remove any tax-related distortions of the decision to marry because all tax-related marriage penalties and bonuses would be eliminated.

The path toward adopting individual taxation in the United States holds one major legal roadblock, rooted in state legal treatment of the income and assets of a married couple. States with a community-property legal regime treat all income and property acquired during marriage as shared equally between husband and wife. States that instead follow a common-law regime assign income to the spouse who earned it. Under a federal system of joint taxation, state-specific allocation of income across spouses does not matter for federal tax liability. In contrast, under a federal system of individual taxation a married couple's tax burden would depend on the state's legal assignment of income.<sup>6</sup> Two couples with exactly the same division of income across spouses could be taxed differently if one lived in a community-property state and one lived in a common-law state. Geographic discrepancies in tax treatment of married couples provided an important impetus for the adoption of joint taxation in 1948, and would again be a problem under a return to individual taxation.

If substantial legal changes were made and federal income tax could be collected on an individual basis across states with different legal treatment of marital property, there would still be many administrative questions to be resolved. Several of these questions involve appropriate allocations of income and expenses between spouses. The idea that income should be allocated to the person who receives that income is straightforward to apply, and to enforce, in the case of wage income. Wage income would be allocated to the spouse who earned it, and the IRS could verify who is earning what, using the third-party reports of wage income filed by employers on W-2 forms. Self-employment income and income derived from asset ownership (such as interest and dividend payments) would present more difficulties. Couples could reduce their combined tax liability by assigning these types of income to the spouse facing the lower marginal tax rate.<sup>7</sup> The IRS could reduce its administrative burden by adopting a rule that nonwage income be split evenly across spouses for tax purposes. A similar rule could be applied to deductible expenses. Importantly, these concessions to practical necessity could be made without eliminating the core benefits of individual taxation for women's labor force participation.

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# Questions and Concerns

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## *1. Could a second-earner deduction be modified to make it more progressive, delivering more of its benefits to low-income families?*

Yes. The benefits of a second-earner deduction could be more targeted to low- and moderate-income households by phasing out the deduction at a lower level of income. For example, Kearney and Turner (2013) outline a second-earner deduction that would reach its maximum value for a spouse earning \$60,000 and that would be phased out starting at a household income of \$110,000.

## *2. This proposal doesn't do anything to promote the labor force participation of unmarried women. Why limit the focus to those who are married?*

Married women face larger tax-related disincentives to work than do unmarried women. The current proposal attempts to target a tax-related solution to the population currently facing the largest tax-related distortions. This proposal could be paired with other policy reforms outside the tax code that promote labor force participation more broadly.

## *3. Why propose a second-earner deduction rather than a second-earner refundable tax credit?*

Unlike deductions, refundable credits can be of benefit to the poorest tax filers—those with zero taxable income. I have chosen not to propose a refundable credit to prioritize the objective of increasing labor force participation over the objective of increasing progressivity. The refundable EITC already provides a powerful work incentive to individuals (particularly parents) at the lower end of the income distribution. The goal of my proposal is to extend work incentives to a different set of individuals.

## *4. The benefits of a tax deduction are typically received in a lump sum at the time of tax filing. Are there ways to alter the policy so that second earners would receive the benefits as higher take-home pay spread over the course of the year?*

When workers start a new job, they complete a W-4 form with instructions about how much tax should be withheld from paychecks during the year. This form already includes a place to report marital status. It would be relatively easy to add a question about whether one's spouse is employed, and withholding could then be adjusted for two-earner households. I would recommend adjusting withholding as if a taxpayer is in the lowest tax bracket. This would ensure that the lowest-income households receiving the deduction, likely those who will benefit the most from having benefits spread over the year, will have most of their benefit delivered in the form of higher take-home pay during the year.

## *5. What about a system in which couples choose between joint and individual taxation? For example, Washington, DC, uses a single set of tax brackets that does not distinguish by marital status. Married couples can choose to report and pay taxes on their combined income, or they can choose to have each spouse taxed individually.*

This is an intriguing possibility that has the potential to both increase wives' incentive to work and reduce marriage penalties. Less desirable is the potentially greater compliance burden of couples figuring out which approach is best for their situation. Additional discussion of the District of Columbia system is provided by Rivers (2013).

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# Conclusion

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When joint taxation was adopted in the United States in 1948, it likely did not have quite the same implications that it has today. With changes in the social norms regarding employment of women, and employment of mothers in particular, taxes imposed on the income of a second earner might have become a relatively more important influence on labor supply. Moreover, given the variation across households in nonmarket home production, providing tax relief to households with two working spouses could help achieve a more equitable tax system.

These trends make it especially important to revisit the question of how families are taxed. The adoption of a second-earner

deduction would raise the after-tax wages of married women, increasing wives' labor force participation rates while moving the tax system closer to other worthwhile goals. The largest benefits of the deduction would go to wives currently facing large tax-based disincentives to enter the labor market. The deduction would not be particularly difficult to administer as part of the existing tax code. Indeed, there is a precedent for this sort of policy in the U.S. tax system, and both Democrats and Republicans have supported similar policy ideas in the past. This policy will not solve all of the problems related to the tax treatment of families, nor will it be enough to overcome all of the barriers that prevent many women from entering the labor market, but it is a step in the right direction.

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# Author

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Sara LaLumia is an Associate Professor of Economics at Williams College, where she teaches classes on public economics, tax policy, and income distribution. Her research has investigated how the U.S. individual income tax affects individuals' labor supply, educational choices, tax reporting behavior, and other outcomes. She is a co-editor of *International Tax and Public Finance*.

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## Acknowledgments

I would like to thank the participants at the authors' conference at the Brookings Institution for insightful comments, and Audrey Breitwieser of the Hamilton Project for her assistance.

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# Endnotes

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1. Tax return data from 2010 show that, among married couples reporting some wage income and filing jointly, in approximately two-thirds of cases the husband earns more than half of the couple's total wage income (Pierce and Guber 2013).
2. See Alm and Melnik (2005) for a detailed discussion of how families are taxed in 30 OECD countries. Only seven of these countries, including the United States, mandate joint filing for married couples. Married couples can choose to file jointly or individually in six countries. The number of countries using joint taxation has fallen over the past 50 years.
3. Data from the Pew Research Center (2015) show that in 2012, among married couples with children under age 18, the husband was the sole earner in 31 percent of cases and the wife was the sole earner in only 6 percent of cases.
4. In 2016 the standard deduction for joint filers was \$12,600 and the personal exemption was \$4,050 for each household member under age 65. Thus, a second-earner deduction would not provide tax relief to childless married couples earning under \$20,700 or to married couples with one child earning under \$24,750.
5. However, eligibility would be restricted to second earners who work for an employer other than their spouses, to avoid the possibility of tax-minimizing transfers within couples.
6. Two Supreme Court cases establish how state marital property regimes affect federal tax collection. In *Lucas v. Earl* the court considered a couple living in a common-law state who had written a contract transferring income earned by one spouse to the other. The court ruled that this contract did not shift the federal tax obligation from the income earner to the income recipient. In other words, the legal ability of couples in common-law states to shift income across spouses in a tax-minimizing way is limited. In *Poe v. Seaborn* the court ruled that a couple living in a community-property state could report income acquired during marriage as being split equally across spouses, and be taxed accordingly. This generates an income-splitting advantage for married couples in community-property states.
7. In the case of notoriously difficult-to-verify self-employment income, couples could simply report the tax-minimizing allocation of income across spouses, with low probability of misreporting being detected. In the case of asset-derived income, assets could be easily transferred from the spouse in the higher tax bracket to the spouse in the lower bracket. Stephens and Ward-Batts (2004) find evidence of such transfers in the United Kingdom after its switch to individual taxation.

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## Highlights

Sara LaLumia of Williams College proposes a new second-earner tax deduction, equal to 15 percent of the earnings of a lower-earning spouse, to boost labor force participation for married women. LaLumia also explores the challenges associated with a more ambitious shift toward individual taxation of married workers.

## The Proposals

**Enact a second-earner tax deduction.** LaLumia proposes a deduction equal to 15 percent of the earnings of a lower-earning spouse.

**Individual taxation.** LaLumia proposes that, in the long run, a switch be made toward individual taxation of married couples.

## Benefits

The proposed deduction would raise the after-tax return to work for many wives, encouraging an increase in married women's labor supply, and would reduce marriage penalties on average.



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