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Approved For Release 2000/04/18 : CIA-RDP85T00875R001700070008-5

Western Investment in Eastern Europe: Reluctance on Both Sides June 74

Approved For Release 2000/04/18 : CIA-RDP85T00875R001700070008-5

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Intelligence Memorandum

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ER IM 74-8
June 1974

Copy No. 67

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Date Impossible to Determine

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Western Investment in Eastern Europe: Reluctance on Both Sides

KEY JUDGMENTS

Large-scale Western investment in Eastern Europe seems unlikely because of the reluctance shown by both sides.

Most countries remain off limits to investors:

- Only Yugoslavia and Romania are energetically seeking foreign investments;
- Hungary has adopted an investment law but considers investment to be an "exceptional and marginal recourse;"
- Poland remains equivocal on the equity issue;
- Bulgaria, East Germany, and Czechoslovakia continue to prohibit equity investment.

In countries with investment laws, investors:

- Are often deterred by the export promotion provisions of the laws;
- Find the negotiating process frustrating;
- Are confused by Communist terminology and concepts;
- Make investments mainly to promote their own exports rather than to earn equity profits.

Note: Comments and queries regarding this memorandum are welcomed. They may be directed to [redacted] of the Office of Economic Research, [redacted]

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DISCUSSION

Introduction

1. Eastern Europe's heavy reliance on the industrial West for key technological inputs to sustain growth has put an increasing strain on the countries' balances of payments. Since the early 1960s, East European policymakers have sought better ways to harness Western technology and, at the same time, to lower the hard-currency cost of the acquired know-how. Their experiments have now brought them to the point of allowing Western equity investment in joint ventures with domestic firms. In 1967 Yugoslavia was the first socialist country to legalize foreign investment, and Romania in 1971 and Hungary in 1972 have followed suit. Early in 1974 Poland reportedly was readying a foreign investment law, perhaps in time for the five-year plan beginning in 1976. East Germany, Bulgaria, and Czechoslovakia have made no moves to relax their bans on foreign ownership.[1]

Why Foreign Investment?

2. In the early 1960s Eastern Europe began going deeper in debt to purchase Western equipment and technology to accelerate growth in leading sectors such as chemicals, petrochemicals, machinebuilding, electronics, and transport equipment. As a first step, the countries purchased licenses and processes from Western firms in addition to much of the equipment needed to produce the products. This arrangement was not altogether satisfactory. The price of the licenses was high and the documentation frequently carried restrictive marketing covenants prohibiting sales outside the purchasing country. And by the time the licenses could be put to use, the technology was often out-of-date, yielding products which had limited hard-currency export prospects.

3. The balance-of-payments pinch – first felt by the countries least tied to trade with the Comecon area, Yugoslavia and Romania – provided an impetus for experimentation. Beginning in the early 1960s, these countries, along with the forward-looking Hungarians, led the search for alternatives to outright purchases of industrial assets. Hoping to make Western technology more productive and to offset the hard-currency cost by promoting exports, policymakers turned to cooperative ventures and coproduction arrangements. The East Europeans expected these ventures would lead to jointly-produced goods that could be sold in the West through the Western partner's marketing channels. The deals actually brought to fruition varied from simple subcontracting arrangements in which the domestic partner added small parts to an almost completed product to more complex situations where the Western partner provided capital, entrepreneurship, and markets while the Eastern firm was supplying plant, labor, and raw materials.

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1. For a description of the Yugoslav case, see ER IR 73-25, *Western Investment in Yugoslavia: Will it Make a Difference?*, December 1973, CONFIDENTIAL.

4. Although some cooperative arrangements worked well in terms of acquiring new technology and establishing new export outlets, the results often disappointed the East Europeans. The Yugoslavs, in particular, complained that they were unable to obtain the most advanced technology and that Western firms used the guise of cooperation ventures to take advantage of liberal customs treatment and thus promote their exports in Yugoslavia. The more advanced Hungarians have had somewhat better success – about 20% (some $20 million) of their machinery exports to the West were attributed to cooperation deals in 1973.

5. To increase their exports, the East Europeans also set up cooperative ventures and even permitted equity deals with Western firms outside their boundaries. Many of these ventures were located in Vienna so that the jointly-owned firms could take advantage of the city's vast financial and switchtrading facilities.[2] Again, the main objective was to use the Western partner's marketing channels to promote East European exports in third countries.

6. The Yugoslavs were the first to decide that cooperation ventures – either in or out of the country – were not enough to make a major contribution to economic development. Already heavily in debt to the West, Belgrade singled out foreign investment as a new means for securing new technology and cutting import costs. But the Yugoslavs stopped short of permitting direct Western ownership of socialized enterprises. Instead, investment up to 49% was to be permitted, within the socialized sector of the economy only. After several years of watching the Yugoslav experiment from the sidelines, the Romanians in 1971 and the Hungarians in 1972 have also moved to allow equity investment.

The Rules of the Game

7. Basically all of the countries with investment laws – Yugoslavia, Romania, and Hungary – have similar objectives. The countries want to acquire state-of-the-art technology in key sectors, management skills, and access to hard-currency export markets. While they are willing to accept marketing of a share of a joint venture's output in their home markets, all expect exports to be the source of funds for the foreign partner's profits and equity repatriation.

8. At the same time, the countries seek to procure these benefits with as little disruption to the political landscape as possible. None of the countries has ever permitted the foreign partner to assume more than 49% of the equity in

2. Vienna is the center for intermediaries (switchtraders) who find third party buyers for products swapped between two firms. For instance, a joint venture involving a Western machinery manufacturer is set up to produce shoes in which the foreign partner is paid partly in kind. The foreign partner, not interested in marketing shoes, may employ a switchtrader to sell the output or switch the shoes for a product he can use.

any venture, even though it is theoretically possible in Hungary, Yugoslavia, and Romania. Foreigners are neither permitted to set up wholly-owned subsidiaries nor are they allowed to set up ventures with private citizens. All investments must be made in conjunction with ongoing socialist enterprises and must be approved in advance by the government.

9. Standard requirements for equity ventures are that they promise to promote "exports, expansion of markets, modernization and reequipment of existing capacity, the introduction of modern technologies, and high labor productivity." Since the investment laws in all of the countries have a barebones generalized approach, most of the approved contracts are extremely detailed. Management prerogatives are expressed in the contract as are export plans, bookkeeping procedures to be followed, default and damage claims settlement, and arbitration proceedings to be implemented if disputes arise. Some contracts, such as that for the Control Data venture in Romania, even go so far as to detail financial and living conditions for personnel assigned to the project.

10. Control of joint enterprises is exercised by a management board. Composition of the board need not reflect the equity position of the partners -- in Yugoslavia Western partners have often obtained parity on management boards even when relatively little was invested. In Romania, the domestic side thus far has had a majority on the board although key decisions apparently are taken only with the unanimous vote of the board. Romania and Yugoslavia both will accept the rulings of the International Chamber of Commerce in Paris in the event of disputes. Hungary is a signatory to the convention and presumably would also accept decisions of the tribunal.

11. The major East European motive for consenting to equity ventures -- promoting hard-currency exports -- represents the key obstacle for potential investors. Western firms are not particularly interested in setting up export industries for the East Europeans, and they clearly do not want to create potential competitors in their own markets or those already served by subsidiaries.

12. Some Western firms are willing to enter into equity ventures to promote exports in areas like the Middle East where, for political reasons, the market is denied them. But few deals fall into this category. Instead most West European firms will be looking at equity ventures primarily as a means of maintaining their presence in Eastern Europe. In Yugoslavia, for instance, investors have preferred small-scale consumer industries with good domestic sales opportunities, a high import content, and a limited export potential.

13. Getting around the rules can be a costly, time consuming, and risky process. Switchtrading avenues can be used to find buyers for hard to sell products, but trading fees are often prohibitive. Many firms which have entered into switch deals with the East Europeans have found themselves stuck with a product that

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is virtually unsaleable or that can be disposed of only at a large discount. The safest approach seems to be to find a product that the venture can produce and then export for a "downstream" operation of the Western partner such as basic chemicals for a sophisticated compound, or simple parts or components used in a finished product. Over time, the East Europeans can be expected to lobby for new technology as it becomes available and to push the Western partner toward allowing the joint venture to manufacture virtually all of the final product.

14. Moreover, Western investors face all of the traditional barriers to doing business in Communist countries. The notoriously slow negotiations that accompany straight sales contracts are only a prelude to frustrations a Western firm can expect to encounter if it decides to negotiate an equity venture on East European soil. Contract discussions for most of the ventures approved in Yugoslavia and Romania dragged on for one to two years. To many firms, the prospect of tying up key personnel for extended periods is simply not worth it. Other firms are not inclined to enter into agreements in which they hold less than 51% of the equity. And some remain unwilling to enter into anything but arms-length agreements -- licensing and barter agreements -- with socialist enterprises.

15. In the absence of East European concessions, Western investors probably would not get enough of a cost break to offset these hurdles. Eastern Europe does enjoy an advantage in labor costs when compared with most West European countries, but its costs probably are on a par with the area in southern Europe. In any case, the East Europeans have made it clear that they are far less interested in investment in labor intensive sectors like textiles than in capital intensive industries such as chemicals, steel and aluminum, and machinebuilding.

Where the Countries Stand --
Romania: Pushing Ahead

16. Aside from Yugoslavia, Romania is the only East European country which has actively sought Western equity investment. Like the Yugoslavs, the Romanians have looked to the West for technology and credit. And like Yugoslavia, the Romanians under Ceausescu have cut an independent niche within the international Communist movement.

17. Although the Ceausescu regime has had its successes -- the national product climbed at an average annual rate of 7% in 1966-73 -- high-pressure growth policies have left behind a legacy of heavy debt to the West.[3] Romanian hopes of cashing in on Western financial circles were a major motivation for seeking

3. For a rundown of Romanian and other East European debt, see ER IM 72-170, *More Growth on the Installment Plan*, December 1972, SECRET.

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membership in the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD) in late 1972. In early 1974 the Romanians even permitted the US based Manufacturers' Hanover Trust to open a Bucharest branch bank -- an unprecedented step for a Communist country. The decision to allow equity investment in one of Eastern Europe's most tightly controlled and centrally directed economies was obviously taken to aid the regime in continuing its growth without incurring more debt.

18. The Romanians have actually permitted equity investment since March 1971. But their original law was so vague that no deals were concluded under it, and the Romanians were forced to proclaim a more complete decree in November 1972. The second law – although still quite general – at least sets a framework for establishment, control, and dissolution of the joint ventures. The law specifies that mixed companies are limited to the fields of industry, agriculture, construction, tourism, transport, and scientific and technological research.

19. The Romanians have made a greater effort than the Yugoslavs to integrate equity ventures with their domestic economy. "Mixed companies" set up under the investment law are required to draw up five-year and annual economic plans for the financial and economic activities of the venture. To guarantee that the venture conforms with Romanian economic objectives, proposed contracts are reviewed by the State Planning Committee, the Ministries of Finance, Foreign Trade, and Labor, and the Romanian Foreign Trade Bank. After signing, the agreement is then rechecked by the Ministry of Foreign Trade for compliance with Romanian law and forwarded for final approval by the Council of Ministers.

20. Although there is no reinvestment provision in the Romanian law, a joint company is required to contribute 5% of its annual profits up to a maximum of 25% of the invested capital to a "reserve fund." Profits remaining after the reserve fund contribution are then taxed at an annual rate of 30%. If a portion of the profit is reinvested for at least five years, the tax rate is reduced by 20%. In addition, the Council of Ministers is empowered to grant a limited tax holiday extending through the year in which taxable profits arise and may reduce the tax rate by 50% during the next two years. These provisions, however, do not seem overly generous when compared with those of many developing countries, which offer full tax holidays of five to ten years.

21. Romanian law is very sketchy in defining profit. "Taxable profit" is simply the "difference between total revenues collected and total outlays made to realize these revenues." The relevant tax decree does not specify such important matters as allowable deductions. Although the foreign investment law permits depreciation of assets as a joint expense, the tax legislation provides neither guidance on methods for computing depreciation, nor does it make clear whether losses may be carried forward or backward to offset taxable income. To cover these contingencies, Control Data included a 38-page appendix in its agreement to

establish accounting procedures and to outline the method of asset depreciation. The agreement specifies that financial records shall be kept in US dollars and that US general accounting methods be used.

22. The response to Romania's investment law has been modest thus far. Only four agreements involving some $12 million in foreign invested capital have been registered to date. Total equity investment for the four projects signed in 1973 amounts to about $25 million. The results are roughly comparable with those achieved by the Yugoslavs in 1968 -- the first full year after equity investment was permitted. A total of five investments were approved by the Yugoslav government in 1968, with a foreign equity of only $17 million compared with a total equity value of $71.8 million. The Romanians apparently hope to induce Western firms into making sizable investment outlays by informally requiring that the firms invest at least 5% of projected total sales volume.

23. The Romanians also are attempting to avoid establishing joint companies that rely heavily on imported components -- a major failing of the Yugoslav experience. Apparently the government expects that within three years, 75%-80% of the output of a joint company should be domestically produced. As the head of a Western firm put it, the Romanian government hardly expects "a mixed company to ... provide work for wrappers of imported parts and components."

24. The four approved agreements involving the Italian firm, Falco di Biella, the US firm, Control Data, Zahnraderfabrik of West Germany, and Dai Nippon of Japan dovetail nicely with the regime's efforts to promote a balanced Western trade policy. As might be expected, all of the ventures are export oriented. They are also linked closely with priority industrial efforts of the government. The Falco di Biella equity investment -- the first approved by Bucharest -- involves a foreign outlay of more than $1 million in the production of acrylic fiber. Some 3,000 metric tons are to be manufactured with most of the output pegged for exports.

25. The widely publicized Control Data agreement with the Industrial Central for Electronics and Vacuum Technology (CIETV) was signed in April 1973 after two years of negotiation. The contract, which establishes the jointly-owned firm of Romcontrol Data SRL, is considered by Romanian officials to be "a model for joint venture agreements." Control Data, with 45% ownership, will contribute $1.8 million in the form of manufacturing and technological know-how and highly sophisticated test equipment; CIETV will provide $2.2 million in plant facilities, tools, and operating capital. The venture will produce peripheral products for computers such as keypunches and cardreaders, which will interface with the Felix computer system built by the Romanians under French licensing. Initial plans call for the sale of 55% of production in Romania with the rest marketed abroad by Control Data. Sales efforts will be directed at Western Europe although Control Data eventually hopes to market the peripherals in Eastern Europe on a hard-currency only basis.

26. There is less information on Romania's other two ventures. Renk Zahnrader's investment with the Resita Machine Building group involves an outlay of $4.0 million out of a total capital of about $8.1 million. Renk-Resita will produce machine gear units for medium-speed marine engines. Half of the output will support Romania's nascent shipbuilding industry -- a priority effort of the regime; 25% will be sold to the West, the remainder to other CEMA countries. The most recent joint venture approved by the Romanians involves the Japanese firm, Dai Nippon, in a project to produce petroleum-derived protein for use in animal feed. A 60,000 ton plant is scheduled to be constructed by 1975 with an investment of about $5 million by Nippon. Export plans have not yet been announced.

27. Bucharest is taking dead aim on attracting US firms for future joint ventures. Romanian officials have discussed potential projects with US firms such as General Tire, Pfizer, and Warner-Lambert in priority sectors like the chemical industry and machine tools. Advanced discussions apparently have been reached with the Cummins Company for the joint production of diesel engines, and "memoranda of intent" to enter into equity arrangements have been signed by ITT in telecommunications equipment and Singer in business machines.

Hungary: A Law Without Ventures

28. The Hungarian approach to equity ventures is perhaps the most curious in Eastern Europe. In a 1970 decree, Hungary in theory became the first CEMA country to permit equity investment. However, enabling legislation to implement the 1970 decree was not completed until October 1972. The Hungarian law mirrors those in effect in Yugoslavia and Romania; the share of the foreign partner is limited "in general" to 49% and transferability of profits and equity abroad is guaranteed. Like the Romanians, the Hungarians require that the joint venture set up a risk fund -- in this case equal to 10% of the venture's capital. Furthermore, Hungary requires that the annual profit fund -- after the risk fund contribution has been deducted -- may not exceed 15% of the total wage fund. Hungary's tax rate is set higher than in either Romania or Yugoslavia. Profits are taxed at 40% if the profit rate is less than 20% of the venture's capitalization; 60% if profits are above that level.

29. The official government position on equity participation, as stated in November 1972 by Odon Kallos, President of the Hungarian Chamber of Commerce, is that it is "a marginal and exceptional recourse." In March 1974 talks with a US Commerce delegation, Foreign Trade Minister Biro was also negative on the investment issue, stating that a large number of joint ventures was unlikely until the Hungarian forint was convertible and the internal price system was revised to reflect world prices. Neither seems imminent.

30. Four years of Hungarian reticence has not prevented negotiations. A number of Western and US firms have been talking about joint ventures -- including

Control Data, Corning Glass, Ford, and Esso. None has been given a green light, although the Hungarian government reportedly was close to approving an equity investment by the West German firm, Siemens, in June 1974. Nonetheless, Budapest still seems largely content with the standard forms of cooperation in which it has been the CEMA pacesetter. In view of their interest in Western and US agricultural and food processing equipment, chemicals, pharmaceuticals, medical instruments, and electronics, the Hungarians selectively may approve equity participation by Western firms if there is no other way to consummate critical deals.

Poland: Still Ambivalent

31. The Polish position on foreign investment has vacillated from statements that a law was being actively discussed to criticisms of the laws adopted by Hungary and Romania. As early as October 1972, the Polish Vice Minister of Finance stated that the Poles were studying the joint venture concept, but nearly two years later no investment law seems to be on the horizon. The Deputy Foreign Trade Minister said in early 1974 that while enabling legislation was still being considered, the Poles thought the Hungarian and Romanian laws were "not of key importance."

32. On the other hand, a number of Polish officials appear to be keeping the door open by maintaining that existing laws already provide the necessary framework for joint equity ventures. According to the deputy chairman of the Polish Planning Commission, the fact that a decree on joint ventures has not been published does not constitute a legal prohibition since a basic policy decision to allow equity ventures was contained in a 1971 resolution of the Polish Council of Ministers. In a similar vein, a senior advisor in the Ministry of Foreign Trade asserted in February 1974 that the necessary legal authority still exists from the pre-Communist period, and that interested companies should not wait for new regulations. If a new law does eventually emerge, the odds are that it will be patterned after the existing legislation in Hungary, Romania, and Yugoslavia.

33. The issue may well be brought to a head if current Polish trade trends continue. Under Gierek, Warsaw has become Eastern Europe's most eager customer for Western technology. Imports from the Developed West have jumped from about 25% of all imports in 1970 to more than 40% in 1973, while the West takes just over 30% of total Polish exports. The result has been a soaring hard-currency trade deficit that reached $1.2 billion in 1973. And the 1974 plan calls for more of the same, with another hefty boost in imports from the West. Like the leaders in Romania and Yugoslavia, Gierek may eventually decide that the country's 200 odd cooperation and licensing arrangements with Western firms are not generating sufficient exports to offset the country's mounting credit obligations.

34. In the meantime, Western businessmen are stuck with the thorny problem of trying to negotiate a deal in the absence of clear-cut directives. Recent Western and US offers from firms such as Dow Chemical, Colgate, Scientific Design, and

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Anaconda Copper have drawn a blank from Polish Foreign Trade Organizations. Although Polish ambivalence may deter other Western firms from exploring the equity avenue until legal issues are clarified, Poland is a good prospect for becoming the next CEMA country to allow equity investment, especially if purchases of Western technology continue at their recent high level. And from the investor's standpoint, Poland offers the largest East European market, a sound raw materials base, and a better than average rate of economic growth.

The Rest: Equity Still Illegal

35. The other East European countries -- Czechoslovakia, Bulgaria, and East Germany -- are even further away from permitting any kind of equity participation. The Czechs and Bulgarians even go so far as to prohibit foreign investment. Although the East Germans have no formal ban, they have hardly encouraged cooperation ventures let alone equity ventures. Except for vague hints, none of the three has indicated that equity investment is even being considered. For instance, according to the Bulgarian Vice Minister of Trade, the concept of equity is considered to be "outmoded" in Bulgaria.

36. Unlike the Czechs and the East Germans, however, the Bulgarians are moving ahead with some of the largest coproduction ventures ever seen in Eastern Europe. A memorandum of understanding signed with Kaiser Industries carries a potential project value of as much as $17 billion to $20 billion over a ten-year period. If the projects envisioned in the Kaiser agreement are to be realized, the Bulgarians expect that Kaiser will provide most of the machinery, technology, marketing expertise, and financing needed. Bulgarian labor and materials will be used as much as possible in local construction. As in equity ventures, proceeds from sales abroad will be the source of Kaiser's earnings.

Lessons from the Yugoslav Experiment

37. Romania, Hungary, and presumably Poland have essentially emulated the Yugoslav format for investment. Nonetheless, they present the investor with a considerably different investment environment. First, their economies are more stable than is Yugoslavia's; second, the enterprises in all these countries are subject to more central control and red tape. It may prove to be just as hard to insulate investors in these countries from bureaucratic frustrations as it has been to isolate them from the impact of inflation and confusing policy changes in Yugoslavia. Aside from these basic obstacles, however, the future of foreign investment in Eastern Europe will depend to a large extent on how these countries react to the lessons of the Yugoslav experience.

38. At a minimum, the limited response of Western firms to the opportunity of operating in the relatively open environment in Yugoslavia ought to have made the East Europeans more realistic about foreign investment. They now should

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expect that most Western firms will be intent on making sales, investing a minimum of equity, and marketing as little of the venture output in the West as practicable.

39. To counter this problem and attract more productive and rational investment, the CEMA countries -- and Yugoslavia -- might well recast their investment laws in the light of import substitution rather than export promotion. After carefully determining industrial priorities, governments could allow foreign companies to set up joint ventures that rest on an adequate raw materials base and use locally produced inputs to make products for domestic consumption. This might prove more efficient -- and cheaper -- in the long run than indirectly promoting ventures that rely heavily on imported components to produce high cost products with a limited export market. In Yugoslavia, domestic political considerations probably preclude the federal government from relaxing export provisions in the near future. Regional pressures for competing ventures would be great, and it would be politically difficult for the federal government to set unambiguous industrial priorities. The governments of the more closely controlled CEMA countries, on the other hand, are less attuned to regional interests.

40. Removing the onus of export promotion and establishing clearcut procedures from the outset for the repatriation of profits and equity would go a long way toward improving the operating climate for Western firms without much harm to the East Europeans. In retrospect, Yugoslavia could have landed far more investments if its law had been clearer and less insistent about promoting exports. If they changed the focus of their laws, the East Europeans might find that they could pick and choose among a greater number of Western offers. Carefully worked out deals involving large equity investments by Western firms might make a greater contribution to domestic output and efficiency than have the classic credit purchases of machinery and equipment of the past.

41. The operating environment obviously would also be enhanced if the CEMA countries gave special treatment to joint investment ventures. Indeed, Romania has already done this in a limited way. Joint ventures are given priority access to raw materials and services and are charged at the noncommercial exchange rate (about 14 lei per $1) rather than the official rate (5 lei per $1). The East Europeans could also consider giving the ventures tax holidays as do most developing and even some developed countries that are seeking investment.

42. But concessions are of course no substitute for a promising profit risk ratio. As the Yugoslav experience suggests, Western firms need substantial profit opportunities before they will make long-range commitments and tie up key management personnel. Moderate profit prospects may elicit interest in small investments with a short payout period, but large-scale projects in priority sectors will require something more in the way of profitability. If the East Europeans really want to reap the benefits of foreign investment, they must be prepared to pay for it.