What economic future for Ukraine?

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Abstract

Ukraine is a new country with a long past. It is a country conflicted between a dual heritage, Western and Russian. The questions about its identity are rooted in the legacy of the Austro-Hungarian Empire and the Russian Empire. The 1990 transition from the Soviet Union failed when compared to the achievements of its neighbors.

Ukraine could be one of the richest country in Central Europe but the current armed conflict between the Kiev government with the separatists in the East threaten its future. Rather than continuing the military confrontation a better outcome would be to separate the country into two parts: a Western and Southern part and an Eastern part. This paper argues that Ukraine democracy and economy will then benefit once the political situation is finally settled or stabilized. The economic path Ukraine chooses will be determinant for her future.

In the Prologue we review Ukraine complex history. In Section One we underline the importance of Ukraine crisis of identity, corruption and the causes of her political instability. In Section Two we review the reasons of a failed transition from the Post Soviet era. In Section Three we give an overview of the Ukrainian economy and in Section Four we defend the merits of partition or separation. The conclusion follows
Prologue

“Prior to the Twentieth Century, there was not “Ukrainians” to speak of, at least in an official sense. Tsarist Russia built its national identity on the idea of Slavic unity, of which Ukraine was a fundamental and inseparable part”(1)

Ukraine has been an independent country for less than 25 years. The history of the Ukrainian people and culture is the result of diversified cultures and peoples.

Western Ukraine was tied to Europe as early as the Middle Ages. Middle Ukraine, a collection of vast steppes long controlled by the Cossacks had little contact with Europe. Eastern Ukraine has always been close to Russia and over time has been populated with a majority of Russian migrants with some Germans, French, Belgians, English and other nationalities.

What constitutes Ukraine today belong at times to the Soviet Union, Austro-Hungary, the Russian Empire, Hungary, Rumania, Poland, Lithuania, Turkey and the Crimean Khanate. According to Timothy Snyder Ukrainian history lacked continuous development from the Middle Ages to the present. (2)

In the XI th century, Kyvian Rus (Ruthenia) was the largest state in Europe. During the XIVth century, Poland and Lithuania fought against the Mongol invaders and by the XVI th century much of the territory of Western Ukraine was part of the Polish-Lithuanian Commonwealth, a multi-lingual, multi-ethnic and multi-religious entity where Poles, Germans, Lithuanian and Jews migrated. Later the Commonwealth evolved into four nation states: Poland, Lithuania, Ukraine and Belarus. From the late XV th century until the Ottoman conquest, the Genoese had colonies in Crimea.

Later the Commonwealth evolved into four nation states: Poland, Lithuania, Ukraine and Belarus. By the XVII th century the Cossacks who had been enlisted to defend the Commonwealth against the Tatars rebelled and formed a Cossack State (Hermate). In 1795, Catherine the Great conquered much of what is today’s Ukraine for Russia and the Western part of Ukraine fell under the Austrians. In the XIX th century as a result of the Russo-Turkish war, the Ottomans lost control of South-Central Ukraine while Hungary continued to rule over the Tran Carpathian region. Ukraine first became independent in 1917 but by 1919 the Ukrainian Soviet Socialist
Republic joined the Soviet Union. The great famine of 1932-33 killed an estimated 3 to 5 million Ukrainians. In 1939 Galicia, South Bessarabia, Northern Bukovina and Carpathian Ruthenia were added to the Soviet Union as a result of the Molotov - Ribbentrop Pact. During World War II Ukraine was occupied by the Third Reich, some of the population collaborated with the Nazis and Ukrainian nationalists exterminated tens of thousands of Poles and Jews. In 1948 Ukraine was made a founding member of the United Nations. This was part of a deal with the United States in order to ensure a degree of balance in the General Assembly. In 1955 Crimea was transferred by the Soviet Union to Ukrainian SSR. With the collapse of the Soviet Union in 1991 a referendum was held. Over 90% of the population approved the separation of the country from the Soviet Union. In 2005, during the Orange Revolution, the election of Viktor Yakunovich, a pro-Russian candidate was annulled because of fraud and Viktor Yuschenko was elected president. In February 2014 Viktor Yakunovich ran again and was elected president mostly thanks to about half a million votes from Crimea. Yakunovich refused to sign a treaty of association with the European Union, The Kiev EuroMaiden protests followed and Yukunovich fled to Russia. In March 2014 Russia annexed Crimea and pro-Russian rebels started an insurrection in Eastern Ukraine.

**Section 1- Identity crisis and challenges to democracy.**

While many in the population are hostile to Russia others are conflicted and remain attached to their Russian roots. The diversity of Ukrainian identity stems from history, religion, language, culture and geography. Many other countries in the world have great diversity and division between East and West, North and South but the divisions in Ukraine society continue to be persistent.

*Linguistic, cultural and religious divisions between East and West.*

The language issue is what precipitated the current crisis. Russian and Ukrainian languages are both Slavic languages but they are different. In the 1930’s Soviet authorities conducted a massive campaign of Russification and discrimination against Ukrainian speakers. Although Ukrainian was the native language for the
majority, Russian was the dominant language for government functions, the media and commerce. In Donesk there were no Ukrainian language schools and in Kiev only a quarter of children went to Ukrainian language schools.

Fig. 1

Since 1991, Ukrainian has been the official state language. A 2012 census counted 50% of respondents considered Ukrainian as their native language while 29% named Russian as their mother tongue and 20% considered both Ukrainian and Russian as their mother tongue. (3). Russian is the majority language spoken today in Donbass and Crimea while there are many ethnic Ukrainians who speak Ukrainian in the Eastern part of the country while in the Western part others speak Russian and prefer Russian culture.

Religious differences

Ukrainian religions are Greek Catholics and Russian Orthodox. There is a small Islamic presence in the former Tartar territories. The complexities between national ideology and religious identity have a long history. Greek Catholics or
Uniates make up about 15% of Ukraine’s population and recognize the Pope as their Patriarch. Most of the Russian Orthodox who live in the Eastern part of the country acknowledge the Patriarch of Moscow as the head of their Church. There are also the Ukrainian Orthodox Church, Kievan Patriarchate and Ukrainian Autocephalous Orthodox Church.

*Corruption, bureaucracy, the political power of the business elite and the pressure of nationalist parties.*

Widespread corruption is facilitated by a weak justice system, poor enforcement of the rule of law, lack of transparency in public affairs. Property rights are distorted by the oligarchs and further eroded by a massive program of property redistribution helped by a large bureaucracy working mostly for the benefit of the business elite.

Given the difficulty to define political corruption and the absence of an internationally accepted definition, the World Bank Institute (WGI) has established the so-called Worldwide Governance Indicators. The 2008 WGI survey ranked Ukraine well below Poland and the Baltic States in terms accountability, the rule of law and the control of corruption. The 2009 Annual Corruption Perception Index (CPI) used to compare countries for transparency has ranked Ukraine 146 out of 180 countries alongside Zimbabwe, Sierra Leone and Russia. As a result the Ukrainian shadow economy is one of the biggest in the world, about 50% of GDP according to the IMF. Underground businesses do not pay taxes and Ukrainians give bribes because they know it is expected from them. Some writers have calculated that 1% increase in the corruption index would reduce the country growth rate by 0.545% (4)

Ukrainian Regulations are numerous and change often. Bureaucrats can exert considerable discretion over allowing, restricting or imposing sanctions on economic activities and there is no credible mechanism for the citizens to control the administration. Ludwig von Mises who was born in Limberg (Lviv) during the Austro-Hungarian Empire remarked in his book “Bureaucracy” that bureaucrats
cannot replace the incentives and the decision making of individuals and the entrepreneurs. He further argued that such a state has unlimited opportunity to either destroy a business or to confer privileges. In Ukraine the real property owners happen to be those who head the government and their allies among the business elite.

During the 2004-2005 Orange Revolution, Ukrainians gave mass support for political and economic reforms. However a 2001 public opinion survey had shown different views of the meaning of national identity. In Western Ukraine a national identity was associated with pro-democratic and pro-market orientations. In the Eastern part, anti-democratic and anti-market orientations was associated with Slavic identity (5).

Since 1991 economic and political power has been in the hands of the economic elites, the oligarchs. Billionaires like Vicor Pinchuck is married to the daughter of former Ukrainian president Leonid Kuchma, Yulia Tymoshenko, known as the “gas princess” was a former Prime minister who made her fortune in the 1990’s in the natural gas industry. During Yanukovich’s short presidency, $37 billion are said to have disappeared. Ukraine current president Piotr Porochenko, the confectionary magnate, is one of the richest oligarch, owner of a main television channel, a previous minister of trade and economic development and a close associate of Serhiy Tihipko a major Ukrainian oligarch. Igor Kolomoisky who owns Privat Bank, controls a paramilitary militia and owns one of the largest commercial bank in the country and who has been at the center of a web of questionable financial transactions. Kolomoisky was fired recently by the President of Ukraine as the governor of the Dnepropetrovsk region (6). Serhiy Taruta another oligarch remains the governors of the Donetsk province.

Another challenge to democracy has been the political instability caused by extreme rights groups and pro-Nazi movements with a populist ideology promoting a radical form of nationalism. Although the nationalist extremists are small in number, Right Sector received only 0.7% of the votes during the last election they are often violent and have achieved a significant level of
representation and influence. A member of Svoboda, the name adopted by the Social-National Party in 2004, became the Minister of Defense. Svoboda members control the prosecutor general office, the deputy prime minister position and the ministries of ecology and agriculture. However, Russia propaganda has exaggerated the threat of such groups which are are still a minority.

Section 2 - Failed economic transition following the Post Soviet Era.

Since the fall of the Berlin Wall, the countries of Eastern and Central Europe have succeeded in developing a market economy along with greater democracy. Countries like Poland and Estonia achieved successful political and economic transitions, with free elections and the emergence of a market system. Ukraine between 1991-2014 had practically no economic growth.

The GDP of Ukraine in 1990 was equal to $81.46 billion US dollars while the Polish GDP that year amounted to $64.55 billion but rose to US $470 billions by 2012 while Ukraine GDP in 2012 stood only at 176 $US billions and ranked after Bosnia Herzegovina and Belarus* (7).

A privatization program started in 1993 was very slowly implemented. By 1997 more than 50% of businesses were put under such a program but by 1998 a large number of firms (over 1500) were classified as strategic and were excluded. Foreign investments remained very limited. The failure of a privatization program prevented the creation of a large national capital and sweeping changes in property rights. GDP per capita fell from about $9,000 in 1990 to a little over $6,000 in 2012.

Ukraine suffered a major depopulation. In 1990 total population stood at about 52 million and by 2012 population fell to 45.4 million (including Crimea). A drop of 13%. (8.) Since the conflict in the East total population has further declined. Ukraine had a birth rate for January–November 2014 of 10.9 per 1000 population, one of the lowest in Europe and a total fertility rate of 1.53 of children per woman compared with Russia of 1.69, Belarus of 1.62 GDP per capita of Ukraine,
<table>
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<th>Poland</th>
<th>Hungary</th>
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<td>1696</td>
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<td>2013</td>
<td>14680</td>
<td>13760</td>
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<td>4024</td>
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Source: Ivan Kushir Research Center- Billion US $.

Fig 2-

Poland’s GDP per capita is today more than three times larger than that of Ukraine. After twenty years since the transition, Ukraine per capita GDP level is lower than in 1990. Ukraine also fell to diversify her foreign trade. More than 50% of imports are still coming from the Russian Federation, including over 70% of natural gas and petroleum products. (9)
The Ukrainian economy is very dependent on the export of industrial commodities, raw materials, and chemicals which account for over 50% of the total Ukrainian exports. While high value exports like machinery and transportation vehicles account for less than 15%. Such concentration to raw materials and metals make these exports more subject to the volatility of commodity prices and to international financial crisis. It has lead to lower export and tax revenues.

Post communist Ukraine failed to follow the shock therapy adopted by Poland but instead adhered to a slow and inconsequential transition policy. The hyperinflation of the early 1990s resulted in a massive monetary expansion in order to finance government spending and state support for loss making enterprises. Constant budget deficits and a negative balance of trade led Ukraine to be heavily indebted. Instead of adopting a gradual crawling devaluation like Poland between 1991 and 2000, Ukrainian central bank replaced in 1996 the old currency, the Karbovanets with the Hryvnia. The Protection of the currency drained central bank reserves from about $40 billion in 2011 to less than $12 in 2013 36.1. In the face of a sharply declining output the National Bank of Ukraine increased M2 from One billion UAH to 906 billion resulting in an increase of inflation by double digits. The Independence of the Ukrainian Central Bank is often compromised by politicians and the business elites.

Ukraine had consistently a high inflation rate: 401.1% in 1994, 29.5%. In 1998 The Inflation Rate in Ukraine as reported by the State Statistics service of Ukraine averaged 36.14 percent from 1995 until 2015. In the mid-1990’s inflation reached 10.000 per cent. Cukierman/WebbNeyapti (1992) have shown that the mean and variance of inflation are negatively correlated to the degree of Central Bank independence.

As shown in Fig 3, Ukraine suffered a great decline in the GDP in 1990-1992 and again after 2008 and by 2013 it is well below her neighbors Russia, Poland and Hungary.
During the Post-Soviet era the development of Ukraine was lopsided and favored the Eastern part of the country with its huge mineral resources: 107 billions tons of coal reserves in the Donbass region, a large iron ore complex at Krivoi Rog and the largest European manganese mine at Nikopol. All these raw material resources essential for steel making enabled the USSR to build a large heavy industry as well as an important defense industrial complex. A Commodities boom started in the late 1990’s profited manly the oligarchs and prevented the country from diversifying its economic base. The greatest majority of the oligarchs’ fortunes were made in the coal and steel business. Between 1990-2014 they formed large
integrated industrial and financial groups including coal mines, steel mills, banking and the distribution of electricity.

**Section 3- The Ukrainian Economy.**

Ukraine possesses 34 million hectares (84.6 million acres) of arable land as well as 30 percent of the world’s black soil - the most favorable soil for agriculture. The fertile Western part of the country used to be the bread basket of Europe with large crops of wheat, corn, sugar beets, sunflower, fruits and vegetables. Since 1990 the share of agriculture in the GNP has declined from 25% to less than 15% today. Ukrainian agriculture did not make sufficient structural reforms following the end of the collective farming and state ownership of grain storage and distribution. Ukraine possesses a skilled work force, an emerging high tech industry, a large transportation infrastructure and modern seaports on the Black Sea. Western and South Ukraine have a number of comparative advantages which can allow these regions to be successful on neighboring and European markets.

Many from Western and Central Ukraine view the industrial East as a forest of smokestacks and a burden for the development of the rest of the country. Following the fighting between government troops and pro-Russian separatists, a number of coal mines have been damaged and others closed down because of the lack of explosives. Many Steel mills are shut down or operating at a very reduced capacity. The railway network has been damaged. Exports of steel and raw materials have collapsed. Anthracite exports in 2014 were down 28% and down more than 80% today. Metallurgical Coke exports in 2014 were 40% lower than the previous year and practically nil today.

Since Russia annexed Crimea more than $1 billion in real estate and other assets have been taken away from their previous owners. Shipyards, hotels, farms, gas station and thousands of small businesses and organizations have lost ownership. Property seizures on such a scale did not happen since the Russian revolution. Only a small number of the 300,000 Crimean Tatars deported en masse to Central Asia by
Stalin 70 years ago have returned to Crimea. Since the annexation the Crimean Tatars who do not have Russian passports may be deported or not given residency permits allowing them to stay, to work and to receive education. All foreign banks in Crimea including many foreign businesses have stopped processing payments and only a few Russian companies have moved in. Food costs have spiraled up because Ukraine does not recognize the new border. Food has to be moved by ferry from Russia until a $3 billion bridge is built linking Crimea to Russia. Kiev has cut back on water delivery to the peninsula causing only a fraction of the farmlands to be irrigated and as a result most farmers have stopped planting. Finally the tourist industry is being devastated. The $11 billion the Russian government has pledged for Crimea until 2020 may not be sufficient to meet the basic needs of the region.

15% of the natural gas consumed and bought from Russia by the European Union transits through Ukraine. Russia has indicated at various times that Gazprom may stop delivering gas through Ukraine. In 2006 and 2009 Russia cut off the supply of natural gas affected the delivery to Europe. Ukraine is the main transit route for Russian gas to Europe and receives about $3 billion a year in transit fees. The Bratsvo pipeline, Russia’s largest gas pipeline to Europe crosses from Ukraine to Slovakia and splits into two directions to supply northern and southern European countries. (fig. 4). Recently Russia has been operating the Northern Stream pipeline bypassing Ukraine. A South Stream project has been stopped following objections by the EEC because of compliance with EU energy regulations.. Until the recent conflict, Ukraine was the fifth largest natural gas consumer in Europe.

Heavy industry accounted for about 40% of domestic gas consumption, with 9% of the gas was wasted. Over 60 % of Ukraine’s gas usage comes from Russia and the balance mostly from Turkmenistan.

After the fall of President Yanukovych, Russia raised the price of gas from $268 per thousand cubic meters to $485 pertcm. Coal accounts for about 28%of domestic energy consumption, nuclear about 18%. Most of the nuclear fuel to feed the fifteen Ukrainian nuclear plants came from Russia but recently the country reduced its dependence from Russia and instead buys nuclear fuel from Westinghouse. Finally
the large Dniepr hydropower plant provides more than 10 billion KWH. This plant is essential for supplying Russia aluminum and aerospace industries. In case Ukraine no longer feeds the Donbass region with natural gas and the loss of the Eastern coal supplies will harm Ukraine economy in the short run but over the long run greater domestic sources of energy and conservation would free Ukraine being held hostage to Russian gas.

Ukraine has been struggling for years on the brink of a financial crisis. In the mid-1990’s the IMF loaned Ukraine $3.5 billion and another $2.2 billion in 1998 plus $600 million in 2004 and yet a new $16.4 billion in 2008. In 2010 the IMF further agreed to loan another $15 Billion but stop payments after Kiev failed to make the necessary reforms and cut natural gas subsidies. On March 11, 2015 the IMF approved a new bailout of $17 billion to be paid over for years. So far $4.5 billion have been disbursed but the country may need another $15 billion. On March 15 2015 Ukraine's biggest creditors formed a bloc to prepare for negotiations
with Kiev after the country announced it aims to drastically restructure its $17 billion of its total international debt (11). In the meantime Ukraine hard currency reserves fell to about $7.5 billion and the deficit of Naftogas continues to be a large black hole.

In 2014 inflation rose to 30% and the Ukrainian currency fell to its lowest level in five years (12). While Ukraine remains a nation at war but the policy of fighting for territorial integrity is becoming increasingly unsustainable. In 2014 inflation rose to 30% and the Ukrainian currency fell to its lowest level in five years (12). A better option politically and economically would be to stop the conflict either diplomatically or keeping it as a frozen conflict along the current ceasefire lines and to restructure its economy and finances based deregulation and decentralization.

Section 4-The merits of partition or separation

In the previous sections we outlined Ukraine history, its diverse identity and failed attempts to reform its economy and political system. In the current section we discuss the merits of separation.

The partition of Czechoslovakia in 1993 was done without violence and was legitimized by its citizens. Although Ukraine is being rocked by a violent conflict, the Ukrainian people may be given the choice in the future to agree on separation. It would be a better solution than any solution imposed by an outside force. There are two recent models of successful separation in Europe: Slovakia and Slovenia.

Since its separation with the Czech Republic, Slovakia has enjoyed some of Europe’s highest growth rates and an influx of foreign investments. Following a period of stagnation in the mid 1990’s, Slovakia reformed its taxation, welfare system and consolidated its budget in order to join the European Union in 2004. It adopted the Euro in 2009. Foreign investment attracted by a 19 percent flat tax moved in, mostly from Germany: Volskswagen, Simens, Deutsche Telefon. A cheap labor force, low taxes, a reformed labor code and a somewhat reduced

Nevertheless, corruption and an inefficient bureaucracy still remain serious issues. According to the corruption Perception Index, Slovakia ranks slightly above 40% compared to developed countries like the USA, Germany and Australia ranging between 80% and 90%. (13)

The other example is Slovenia which made a successful transition from a quasi-command economy to a market economy, Slovenia economic model followed a predominantly shock therapy policy with some gradualism in social fields. It was deemed necessary to implement major reforms such as in Poland in order to establish a free market, to attract foreign investments and international financial institutions. To this effect it created new legislation according to democratic principles, a privatization program with free vouchers, a stabilization policy to gradually reduce inflation, a balanced budget, liberalization of international trade, floating exchange rates and no foreign aid.

Only a few isolated voices have recommended that Ukraine should be partitioned or separated. One such voices is from Professor Alexander Motyl who maintains that Ukraine will be better off if Donbass, Luhanks and Donetz were to leave Ukraine. Donbass is a drain on Ukraine and according to him an economic black hole. Ukraine without these two or three provinces would improve the economy and the politics. In the process the country would become more democratic, prosperous and stable.

“Once the war is over, Ukraine would emerge more compact, homogeneous and unified.” (14). Similarly Ron Paul has suggested that Ukraine should split into two smaller countries, one pro-Western and one-pro-Russian. It would promote smaller government, decentralization and self-determination. The Ukrainian national identity might also be strengthened and ultimately the economic
relationship with Russia might resume on a more balanced basis. Western Ukraine has the potential to develop a large agro business and to improve the productivity of its agriculture which has one of the lowest cereal yield in Europe. Ukraine is the world largest producer of sunflower oil. Once a Free Trade agreement is in place with European Union it will open its markets to Ukrainian products. Ukraine has a growing and competitive IT industry with over 50,000 engineers, 500 outsourcing companies, over 100 global R&D centers, more than 100 e-commerce companies and thousands of startups. Because of its location a separated Ukraine would be well place to develop trade with Poland, Germany, the Mediterranean countries and later to integrate with the European Union. In western Ukraine, there is a kernel of modern industries, services and high tech firms which would be able to attract foreign investments rather than in the rust belt of the Eastern part.

Not much analysis based on Austrian economics has been done on transition economics. The record shows that some countries like Estonia, Slovakia, Slovenia grew rapidly without central bank planning and succeeded in developing a robust private sector in sharp contrast with Russia and Ukraine between 1990-2013. Mainstream economists mostly ignored Public Choice warnings about government failures and rejected the insights of Austrian economic analysis.

A Public Choice approach might be recommendable in view of the entrenched bureaucracy and the poor performance of the Ukrainian political process. In the past Ukraine has allocated an excessive amount of its total product through political institutions, often corrupted, instead of the markets. For the sake of efficiency all the different social and ethnic groups need to become part of the economic exchange instead of a group of oligarchs.

Regulations should be limited to help spur entrepreneurial innovations and the development of capital markets. Edward Stringham (15) has shown that excessive regulations can hinder the emergence of financial markets. Peter Leeson’s research
on self-enforcing exchanges has also shown how individual cooperation can function without government intervention and formal institutions.

The lessons of the 2008-2009 financial crisis, however cannot be ignored, especially it is necessary to prevent too high public and private debt ratios. Some macro economic conditions will also be needed to be achieved, notably a strong account surplus, low inflation, a stable exchange rate and ready market access. The birth of a new Ukraine could be led by a younger generation, some of them having studied and worked abroad. They will create businesses and be more engaged in a new civil society.

Russian economists like Sergei Glaziev, economic adviser to Vladimir Putin and Valentin Katassonov disagree and argue forcefully that the Ukrainian economy can only be viable if it remains united and joining the Euro-Asian Customs Union led by Russia.

**Conclusion**

The new Ukraine born during the Maiden's protests is being threatened by a separatist armed conflict. Rather than trying to restore the territorial integrity of the country at great human and material costs, the government in Kiev and the Western Powers should work toward reaching a diplomatic resolution for the separation of Ukraine into two parts. The weight of history, languages and culture is too strong to override deeply rooted cultural, linguistic and economic differences.

A new Ukraine will need to implement a new transition program with the goals of achieving energy independence and the restructuration of a state bureaucracy too often allied with a business oligarchy. An independent Western and Southern Ukraine posses the economic assets for a brighter future in contrast to the heavy industries and loss making mining of Eastern Ukraine. An economic program of radical reforms including limited regulations, a small government, low taxes, limited foreign aid and free market access might be the best outcome for a new separated Ukraine.
Notes

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Fig 1- *Etno-Linguistic map of Ukraine* - Source; the Atlantic 02/20/2014


*Fig 3-GDP growth rate* - *Source : Ivan Kushir research Center*

Fig 4- *Ukraine pipeline connections* - Source: National Gas Union of Ukraine
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