Impact of Financial Pyramids on Well-being of the Russian Society

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Abstract

The article considers the impact of financial pyramids on a man’s well-being in terms of the key domains: financial situation, social environment, education, employment, and health. The authors determinate the financial pyramid as a scheme of interaction of the organizer and participants. In a financial pyramid participants' contributions are not a source of investments and it is redistributed between them. It is important to understand that the participants of a financial pyramid are able to lose contributions. The major negative effects of financial pyramids on socio-economical and psychological wellbeing of a man and society in Russia were revealed. We detected their effect on: 1) a financial situation, i.e. financial losses of participants of financial pyramids; 2) man’s psycho-emotional state; 3) decision-making of various social groups, i.e. intensification of their cognitive distortions. An instrument of social and economic policies of Russia aimed at mitigating negative effects of financial pyramids was suggested and described. The instrument will enable to enhance confidence of population in financial institutions and their services.

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Keywords: Wellbeing, financial pyramid, financial institutions, technology for generating confidence, instruments, e-government.

1. Introduction

Financial pyramids disillusion investors and disturb confidence in financial institutions, undermine financial stability and public safety. Thus, they negatively affect individual and social wellbeing. Making decisions on improving his/her wellbeing, a man cannot fully assess possible negative effects. According to the theory of consumption behavior participation in financial pyramids is disruption of
rational behavior and an inefficient decision, because, despite some profit generated at the initial stage, in the long-run, a man loses his money. Not all participants have exact information about operation of financial pyramids and can predict the moment a pyramid would collapse. Meanwhile, man’s individual wellbeing, conditioned by his financial situation, social environment, psychological and emotional state affects public wellbeing (Burazeti, Goda, Sulo, Stefa, & Kark, 2008).

Therefore, assessment of the influence of financial pyramids on the key domains of wellbeing is essential. It will enable to determine an instrument of the national socioeconomic policy aimed at reducing negative effects of financial pyramids. Obviously, it will contribute to improving financial situation of the Russian population, to increasing employment rate and educational level, to improving social environment of the state, as well as people’s health.

Therefore, the aim of our research is to offer an instrument of enhancing confidence in Russian financial institutions and preventing negative effects of activity of financial pyramids on wellbeing of a man and society. To achieve this aim we must: 1) determine consequences of financial pyramids effects on a man and society according to the key domains of wellbeing; 2) determine an instrument, reducing negative effects of financial pyramids on wellbeing of a man and society in order to enhance confidence in financial institutions.

2. Method and materials

Assessment of the negative influence of financial pyramids on a man and society is based in our research on comparative analysis of socioeconomic and psychological consequences of activity of financial pyramids in Russia against the key domains of wellbeing.

The research is also based on scientific works which deal with the issues of wellbeing (Diener, & Tov, 2007, Ferrer-i-Carbonell, 2005, Lindley, Harper, & Sellen, 2008) and describe the key domains of people’s wellbeing. Issues of consumption behavior are considered in research works of Williamson (1993), Hodgson (2003), Becker (1993) etc. Financial pyramids are studied in works of Lewis (2012, 2015), Cornelius (2009).

3. Results and discussion

Man’s wellbeing depends on many factors: financial, social, physical and psychological. These aspects determine to a large extent man’s behavior, because when making decisions aimed at improving his wellbeing a man might be cheated, fall into a trap of his own cognitive distortions, be interested in generating here-and-now profit. He might also be unable to think several moves ahead and compare all available alternatives to make the only right choice.

Seeking solutions individuals can be motivated by profitability or justice. In real life situation these criteria are often incompatible and contradict one another. An optimality criterion also depends on man’s attitude to risk. Efficiency is associated with an option. If transaction expenses were equal to zero, conclusion of transaction would not require incidental charges, associated with finding information, property rights protection, negotiations. Moreover, a common optimality criterion and solution would be Nash Equilibria (Maskin, 1999). It is a profile of strategies in which each player’s strategy ensures him the best response to other players’ strategies, i.e. a maximum payoff taking into
account the strategies of other players. Thus, none of the players is motivated to change his strategy on his sole discretion. This concept is based on assumption of gain maximization, which every player seeks, and on each player’s rational expectations about other players’ behavior.

One assumption of the first welfare theorem is that economic agents have full symmetrical information about goods and services. Violation of this condition can result in disappearance of some goods markets, because goods with different features become undistinguished for one of the market parties. As a result, resources allocation can be non-optimal if market parties have asymmetrical information. We deal with asymmetrical information in different situations. Let us consider some examples:

- a salesman of a second-hand car is more aware of the car condition than its potential customer;
- a loan-subscriber, applying to a bank, can better assess a credit risk than a bank providing this loan;
- an insured, effecting a policy of medical insurance, is more aware of his health and probability of seeking treatment, than an insurance company;
- a driver, effecting a policy of vehicle insurance is more aware of his driving style (careful/careless), than an insurance company;
- a person applying for a job is more aware of his skills than a company wishing to employ him.

Obviously, possible risks and insufficient information disturb confidence and make it impossible to find an optimal solution, while confidence can reduce decision-making time. In Russia the level of people’s confidence in financial institutions is rather low according to the last years’ results. The maximum confidence is in banks (59 %), while the level of people’s confidence in microfinance organizations is reducing. No significant changes in people’s assessment of reliability of financial institutions have been recorded. If to consider banks and insurance companies separately, confidence in insurers is considerably lower, especially in terms of reliability and transparency assessment (The National Agency for Financial Studies, 2016).

To gain a deeper insight into the problem, let us consider the effects of financial pyramids on the key domains of wellbeing. Table 1 shows the key domains of wellbeing, such as financial security, health, employment, education, and social environment (Global Age Watch Index, 2015).

### Table 1. Key domains of well-being

<table>
<thead>
<tr>
<th>Financial security</th>
<th>Health</th>
<th>Employment and education</th>
<th>Social environment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct (resulting) indicators of wellbeing</td>
<td>People’s positive qualities/abilities (approximate)</td>
<td>Positive social environment</td>
<td></td>
</tr>
<tr>
<td>Income level</td>
<td>Life expectancy</td>
<td>Employment</td>
<td>Social connections</td>
</tr>
<tr>
<td>Poverty rate</td>
<td>Healthy life expectancy</td>
<td>Educational level</td>
<td>Physical safety</td>
</tr>
<tr>
<td>Relative wellbeing</td>
<td>Psychological wellbeing</td>
<td></td>
<td>Civic freedom</td>
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<tr>
<td>GDP per capita</td>
<td></td>
<td></td>
<td>Access to public transport</td>
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Let us consider the effects of financial pyramids on every domain.

**Financial security.** If a man has available cash assets, he can manage them in one of the next ways:

1) open a low-interest account, but with a minimum risk (deposit guarantee);
2) invest money in an enterprise: return is higher, consequently, risk is higher, as profit will be gained only when an enterprise starts generating it;

3) invest in a financial pyramid.

Participation in financial pyramids can be explained with the Prospect theory developed by Kahneman & Tversky (1979). People would rather take a bigger risk to avoid expenses than to obtain extra revenue at a high risk.

Investing in a financial pyramid an individual increases his income at the first stage. However, social wellbeing does not change because, virtually, money is merely redistributed between participants and organizers. The major problem resulting from this redistribution is setting off losses. If a man deliberately participates in such schemes and loses his money must his losses be set off? The choice between efficiency and justice is, finally, the problem of the best distribution of revenues.

**Health.** Participating in financial pyramids, a man agrees to take an unreasonable risk, i.e. he is inclined to gambling and enjoys it. Gaining some money, a man feels happy and his current general state gets better. However, in case of money loss and finding himself at the bottom of a financial pyramid, a man feels stressed, which negatively affects his health (Ryff, 1989).

Employment and education. Participating in such projects a man must be aware of the situation on the financial market and must be able to plan his actions and calculate the result. However, investigations (Filippova et al., 2016) suggest the opposite: people are not willing to plan their actions ahead, they are unaware of financial theory and their decision-making is rather driven by intuition than common sense (The national Agency for financial studies, 2015). Curiously enough, some participants, even having lost in a financial pyramid, invest in it again, which suggests that they don’t learn from mistakes.

**Social environment.** Coming to a decision to participate in a financial pyramid a man is often guided by his friends’, relatives’, colleagues’, famous people’s opinion and opinion of those who have succeeded in this scheme. Radaev (2002) in his sociological research of financial pyramids (evidence from MMM of the 90s) points out that many potential participants of financial pyramids hesitated and came to the offices to watch other participants. Only when they were convinced that other participants received revenues, they agreed to invest their money. Such behavior is the result of a bandwagon effect suggesting that a man follows the actions of others. Meanwhile, if revenue is lost, social ties are splintered. People, who have lost their money as a result of investing in financial pyramids, accuse others as they have given them a bad advice or haven’t reinvested money (for MMM in the 2000s it was a mutual benefit fund).

Consequently, a financial pyramid negatively affects people’s wellbeing. Some measures must be taken to resist it, since a man is not rational and would make repeatable errors resulting in economic losses.

To solve this problem let us consider an appropriate method which could prevent negative effects of activity of financial pyramids. Although the government takes measures targeting ban of activity of financial pyramids, international experience shows that this mechanism is not always viable. For instance, in the USA financial pyramids were banned in the 20s in the 20th century after the collapse of
Ponzi schemes (Frankel, 2012), but in 2008 Madoff’s financial pyramid was revealed (Lewis, 2012). It must be also noted that initially not all organizations are financial pyramids.

4. Conclusion

We suggest developing a concerted strategy on enhancing people’s confidence in financial institutions using information and communication technologies as an instrument of social and economic policy of the state. The strategy will combine current programs on enhancing people’s confidence in financial institutions and their services. They are a state-run program on increasing financial literacy of population and developing financial education in Russia (The World Bank, 2016), regional programs on increasing computer literacy of population, e.g. program in the Tyumen region “Expanding Horizons” (Program “Expanding Horizons”, 2016).

The strategy must be based on technology of enhancing people’s confidence in financial institutions. This social and administrative technology is an algorithm of taking administrative decisions, a sequence of controlling actions enhancing confidence in financial institutions, studying mechanisms of financial management in Russian families, retirement benefit schemes of population, people’s credit behavior, financial literacy, e-money research. Let us outline implementation stages of the social and administrative technology aimed at enhancing people’s confidence in financial institutions: 1) to set a goal which is to be achieved as a result of some activities; 2) to define criteria to assess the quality of financial services; 3) to assess the quality of services provided to people by financial institutions; 4) to prioritize directions to improve the quality of financial services in terms of enhancing people’s confidence; 5) to implement corrective measures within the programs of different levels (federal, regional and local).

Thus, it is necessary to coordinate activity of all Russian institutions, implementing the suggested strategy and economic agents, who the strategy is aimed at, on the basis of e-government (Filippova, 2015). This electronic platform will enable revealing financial pyramids and stop their activity disturbing people’s confidence in financial institutions and their services and decreasing the level of a man’s and society wellbeing. In our opinion, e-government will enable to coordinate activity of all economic agents ensuring assess to exact, reliable and open information, thus, enhancing confidence of the Russian society in financial institutions and their services.

The suggested instrument is targeted at the following groups of people. Firstly, this instrument will enable every Russian family to improve management of their personal finances. Secondly, retirees and prospective retirees will have an opportunity to obtain accurate and up-to-date information, hence, to calculate and wisely manage their pension assets. Finally, it will allow regulating people’s credit behavior, improving their financial literacy, which will positively affect the key domains of a man’s and society wellbeing.

The suggested instrument of the government social and economic policy aimed at eliminating negative effects of activity of financial pyramids enables to enhance people’s confidence in financial institutions and their services.
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