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the role of inheritance

executive summary

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THE ROLE OF INHERITANCE

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SUMMARY OF KEY FINDINGS

Receiving an inheritance can affect how people provide for their retirement. However, little is currently known about the significance of inheritance in New Zealand.

For the purposes of this paper, an "inheritance" is received by someone from a benefactor (usually a family member), and a "bequest" is given by the benefactor (usually in their will).

This report provides some background to inheritance issues and an overview of research into inheritance. It considers:

- the theory about the effect of inheritance on recipients' and benefactors' savings behaviour
- empirical research (mostly from overseas studies) and what it can tell us about who receives inheritance, its importance in accumulating wealth, and its effect on the distribution of wealth in society.

The report provides a foundation from which we can determine any need for future research in this area.

The life cycle theory of saving

The standard life cycle (SLC) model was for many years the basis of research into savings and consumption. The model suggests that consumption and saving decisions are made from a life cycle perspective.

This has implications for people's actions in times when they do not have an income. If they have no savings, the model suggests they will borrow to fund consumption and repay the borrowed funds when they have an income again. However, once a person has retired they may not have the opportunity to earn an income again, so they need to save for retirement while they are earning money. Accordingly, savings are built up during working years and spent during retirement.

A bequest transfers these residual savings, unless they have been converted into annuities.[1] People often use annuities to deal with the uncertainty of whether their savings will last for the rest of their lives.

However, people tend to hold on to ordinary assets rather than buy annuities, for reasons such as:

- a government-provided pension ensures a stream of regular payments and can make an annuity unnecessary
- annuity premiums can be too costly
- they may need to be prepared for unexpected major costs such as medical care
- they may wish to leave a bequest.

[1] *An annuity is the purchase (using a lump sum of money) of a stream of regular payments until the end of life or for a specified time.*

It was not until the last decade that several limitations of the SLC model were overcome, specifically:

- constraints on people's ability to access money when they have little or no money themselves
- people's aversion to taking risk
- imperfections in capital markets resulting in overly costly premiums for annuities
- public pensions being provided.

These enhancements mean the model is better able to explain the close link between income and consumption (which are closer than the SLC hypothesis would imply), and the fact that the elderly have a relatively high holding of ordinary assets, even allowing for any motive to leave a bequest.

The enhanced SLC model classes households into two groups:

1. those who have very little access to credit and so spend virtually all of their income.
2. those who attempt to smooth their consumption over time.

With this distinction, the enhanced SLC model can explain a wide range of savings and bequest behaviour at both the individual and collective levels.

One weakness of the SLC model is its inability to explain the savings and bequest behaviour of the very wealthy. This group accounts for a disproportionately large share of assets, which means that any analysis that focuses on median or modal households cannot be simply scaled up to present a valid picture of the total economy.

Why people leave bequests

While inheritance can play an important role in savings and wealth for the recipient, leaving a bequest is not always intentional.

Bequests can be divided into intentional and unintentional bequests. Intentional bequests include those made for altruistic and strategic reasons. If the altruistic motive is very strong (even extending to future generations) it is usually referred to as the "dynastic motive". Strategic bequests can be seen as the price of being cared for (or even contacted) by one's offspring in old age. Unintentional bequests, in contrast, are the result of excess precautionary savings in ordinary assets (as opposed to annuities).

The reasons for leaving bequests have been investigated for many countries. The altruistic bequest motive has been found to be relatively weak, while the strategic bequest motive is quite prevalent in some countries.

This is consistent with the life cycle model and helps explain why the elderly hold fewer annuities than could be expected.

The relative importance of inheritance in life cycle savings

Overseas evidence suggests that a substantial part of wealth (30% to 60%) comes from inheritance, when total wealth is split into inheritance received and life cycle savings. Figures differ by country. The uncertainty in this proportion partly arises because strategic bequests are actually part of life cycle saving (of the benefactor), although they are not always classified as such.

In the United States it was estimated in 1983 that the flow of bequests to children and grandchildren would have been 20% higher were it not for an increase in the use of annuities. This change may have contributed significantly to the decline in the US savings rate.

The proportion of total wealth attributable to inheritance has implications for life cycle savings. If the proportion is high and expected to remain so, people's savings to fund retirement are likely to be low. The level of public pension is also likely to affect the level of retirement savings and therefore the size of inheritance for future generations. A pay-as-you-go public pension scheme is funded by a young generation for the previous, older generation. This means particularly onerous costs to the younger generation if the older generation is larger than they are. These costs may be offset if the older generation has a strong bequest motive. The tax paid to support pensions would effectively be returned to the younger generation via bequests. While it is not economically efficient to have money cycle like this, a public pension may improve overall welfare as it alleviates financial concerns people may have over the uncertainty of when they are going to die.

The rising life expectancy of those leaving bequests means that wealth is being transferred to middle-aged or older people rather than the young. Expectations about inheritance will affect these individuals' savings rates throughout much of their working lives. If they overestimate the value of their inheritance, their ability to adequately recover from this and prepare for retirement may be limited.

The distribution of inheritance and its effect on the distribution of wealth

Bequests can have a significant effect on the inequality in wealth distribution in many countries, with wealth inequality transmitted from one generation to the next. Significant inheritances are heavily skewed toward the upper end of the distribution of income and wealth. Wealthier people are likely to transfer wealth to similarly well-off members of their family. However, bequests are often intended to address wealth inequality within families. Some are designed to offset differences in siblings' incomes.

Throughout the world, real estate (land and housing) is the most important form of intergenerational wealth transfer in terms of monetary value. This is likely to be at least partially driven by the real appreciation in real estate asset values over many decades in most developed countries.

Inheritance in New Zealand

New Zealand does not have the extremes of wealth of some other countries. As a result, the very wealthy households in New Zealand hold a lower proportion of total wealth than the very wealthy in other countries. Accordingly, these households receive a smaller proportion of New Zealand's total inheritance.

Transferring real estate by bequest is particularly important in New Zealand, given the high proportion of wealth held in real estate. This can affect how comprehensively inheritance is measured in New Zealand, as existing surveys generally do not cover real estate as part of an inheritance. This is explained further in the next section.

Analysis of New Zealand data

This section is an exploratory analysis of New Zealand data on inheritances and gifts, drawn from two years (1994/95 and 1995/96) of the Household Economic Survey (HES). These two years of data provide a sample size of about 5,800.

This survey covers only inheritance income received by the households in a single year – either 1994/95 or 1995/96. It does not measure the total inheritance received by members of the households over their lifetimes.

Other data sources have not been investigated as they are unlikely to yield as much information as the HES. The Deceased Persons Estate Survey has some use in estimating wealth distribution, but has little direct value in a study of inheritance. The Survey is biased towards high-value estates. The Westpac•FPG Household Savings Indicator and the Westpac•FPG New Zealand Savings Profiles have no data on bequests.

This analysis of the HES data is a collection of cross-tabulations of income from inheritance, income from gifts and expenditure on gifts, classified by:

- income decile
- family type
- age
- sex
- ethnicity.

Gifts given and received and inheritances not in the form of income are not generally included, so the analysis omits inherited houses and other such assets. The only exception is if an inherited asset has been sold and the proceeds are classified as deriving from an inheritance rather than as irregular income from the sale of property. Given this omission on non-income assets, the total value of inheritance is likely to be undervalued.

There are few very wealthy people in the sample, so no conclusions can be drawn on this group.

Overall the results show a low probability of either receiving or spending on gifts, and an even lower probability of receiving an inheritance. Note that inheritances by a surviving spouse are not classed as inheritances as this is an intra-household transfer. The amounts received (or expended) are very volatile, especially for inheritances. The mean probabilities and amounts are as follows:

	receiving inheritance	income from gifts	spending on gifts
PROBABILITY	2.8%	7.3%	5.9%
MEAN	$15,000	$2,300	$2,100

Thus, 2.8% of the households in the survey received an inheritance and the average value of that inheritance was $15,000.

The data shows a relationship between inheritance and gift transactions (whether income from or expenditure on) and income, age and family type. The probability of receiving an inheritance is higher in the top 30% of income earners and is concentrated among recipients aged

45-54. This is consistent with most inheritances from parents. The mean amount of inheritance (for those who receive one) does not vary significantly by income or age.

There is a higher probability of inheritance for couples. This is not surprising given they have two sets of parents from whom to inherit. Couples with dependents are most likely to inherit, which suggests the benefactor may have some dynastic motives. These motives may also be compatible with strategic bequests and indicate that such bequests may be intentional.

Income from gifts is slightly more likely for those at the upper and lower ends of the income distribution, and more prevalent among younger age groups and those with dependents. Expenditure on gifts shows little relationship with income except in the top 10 percent of income earners, where the propensity to spend on gifts is about twice the average. Gifting is also more prevalent among those over 45.

Ethnicity is not usually very significant for inheritance. However, gifting behaviour among Maori seems somewhat different from that among other New Zealanders. While Maori households are as likely as others to give gifts, they are much less likely to receive gifts and those they receive are in smaller amounts. Maori may be more likely to give gifts that cannot be attributed to a single household, such as a koha at tangihanga or contributions to marae.

Gifts and inheritances show no relationship with gender, but this would probably not be true if the definition of inheritance included the share of an estate received by an individual when their partner dies.

Recommendations for future research

Given inheritance's potential importance as a source of funds when preparing for retirement, it would be useful for the Office of the Retirement Commissioner to know the relative size of inherited wealth in New Zealand, its distribution, the strength of the bequest motive, and the expectations of those who stand to inherit – whether through intended or unintended bequests. This information could be collecting using the following strategies:

1. investigate the reliability of gathering together HES-based data on bequests, converting it to a stock measure and comparing it with other estimates of aggregate wealth.

2. use the recently updated MIDAS microsimulation model of wealth accumulation to simulate lifetime savings behaviour, taking into account age, ethnicity, marital status, the existence of dependents, income and inheritance.

3. undertake a survey to assess behaviour on the motive to bequest, the expectation of receiving bequests and the actual receipt of bequests.

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