



Financial performance of Chinese airlines: Does state ownership matter?



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ABSTRACT

This study investigates whether state ownership significantly affects the performance of publicly traded Chinese airlines over the 1994–2011 period. The sample consists of six listed Chinese airlines, five on the Shanghai Stock Exchange and one on the Shenzhen Stock Exchange. Panel regression test results display persistently a U-shaped relationship between state ownership and firm performance for the airline industry. Furthermore, the evidenced convex relationship holds true for both market and operating performance measures. Thus, Chinese airlines with mixed ownership perform worse than their heavily privately held or majority state-owned peers. We attribute the poor performance experienced by mixed-controlled Chinese airlines to the grabbing hand exerted by their government shareholders and the excessive agency costs associated with severe conflicts of interest between their managers and dispersed shareholders. The findings affirm and highlight the importance of control and ownership unambiguity. Given the Chinese government's ongoing intention to privatize state-owned enterprises (SOEs) and the demonstrated U-shaped relationship, the optimal course of action for Chinese policy makers and Chinese airline executives to follow in order to further improve the performance of the industry is to expedite the privatization process for all state-owned airlines to break away from their state owners and to become fully privatized. This study enriches finance literature in at least two aspects. It serves as the first attempt to study the impact of state ownership on the performance of Chinese airlines. It also sheds additional light on the dynamic between state ownership and the performance of newly privatized SOEs while adopting multiple performance indicators and performing panel regression tests under three estimation methods.

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1. Introduction

Chinese government, as evidenced in Qian (1996) and Che and Qian (1998), plays an important role in corporate governance and firm performance. State shares account for the largest ownership of listed firms and constitute a source of intervention by the Chinese government. However, literature addressing the relationship between state ownership and Chinese firm performance has not resulted in a consensus. For example, Qi, Wu, and Zhang (2000) and Li, Sun, and Zou (2009) illustrate the detrimental impact of state ownership on firm performance; Chen (1998) and Le and Chizema

(2011) support the enhancement role of government ownership to corporate performance; Sun, Tong, and Tong (2002) and Tian and Estrin (2008) display a quadratic relationship between state ownership and firm performance.

Nevertheless, these studies may undermine the performance or risk of firms in a variety of industries. This research attempts to eliminate this noted potential complication by directing its attention solely to the effect of state ownership on a single Chinese industry, namely, the airline industry. It analyzes the impact of state ownership on Chinese airline companies' profitability, market performance, solvency, and operating efficiency.

The tourism industry in China has expanded rapidly since the Chinese government adopted the open-door policy and launched the first phase of its economic reforms in 1978. According to the 2013 edition of Tourism Highlights by the United Nations World Tourism Organization, China ranked first in the world in 2012 in

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terms of international tourist arrivals, with a total of 95.07 million to Mainland China, Hong Kong, and Macao. Its international tourism receipts of \$114.58 billion in 2012 ranked second in the world. The same publication also shows that China became the largest international tourism spender for the first time in 2012, setting a record \$102 billion in expenditure.

China's domestic tourism has also capitalized on its large population and fast economic growth. 2011 data compiled by National Bureau of Statistics of China put the number of domestic travelers at 2.641 billion and tourism expenditure incurred at 1930.54 billion in Renminbi (RMB), growing almost 5 times and 19 times, respectively, since the end of 1994 and making China the biggest domestic tourist market in the world.

Naturally, the fast expansion in both the domestic and the international tourism markets in China has energized the Chinese airline industry and propelled China to gain the status of the fastest growing aviation sector in the world. According to a 2013 [International Air Transport Association \(IATA\)](#) press release, China's domestic air routes will make up 195 million of the 930 million new travelers projected for 2013–2017 and another 32.4 million of those will be flying to or from China via international routes, representing the single largest driving force for global air passenger growth ([“Airlines expect 31%,” 2013](#)). The projection, along with China's geographical location at the center of the fast-growing East Asian air travel market, means that the phenomenal growth featured in the Chinese airline industry will continue in the foreseeable future.

Based on Boeing's 2013–2032 outlook released in 2012, Chinese airlines will need almost 6000 new airplanes at a total cost of \$780 billion, accounting for more than 40% of Asia-Pacific region's forecast demand. The report projects China's GDP as a percentage of the world's GDP to nearly double over the 20-year span from 8.5% to 16%. Over the same time period, China will see its domestic travel and international travel to grow at an annual rate of 8.8% and 7.2%, respectively ([“Current market outlook,” 2013](#)).

To empower Chinese airlines to take advantage of economic growth and to adapt to market changes, the Chinese government has resorted itself to aviation reforms. Based on [Le \(1997\)](#), [Zhang \(1998\)](#), and [Chow \(2010\)](#), several significant developments define the aviation reforms. First, the 1985 approval of the *Report on Reforming the Management Structure of Civil Aviation* prompted the Civil Aviation Administration of China (CAAC) to relinquish its airline management duties while retaining administrative and regulatory charges. This, in turn, set the previously centralized and monopolized industry off for liberation and autonomy.

Marketization followed next, featuring CAAC's spinoff of its residual airline operation, establishment of new airlines, and consolidation and merger of small carriers. To further strengthen market economy and to boost China's bid to join the World Trade Organization, CAAC in 1995 abolished its domestic resident fare discounting practice, leveling the playing field for domestic and international aviation services.

Corporatization, essentially privatization in Chinese style, characterized the latest stage of the reforms. It embodies an open-market economy with state-owned enterprises (SOEs), enabling a unique mix of capitalism and socialism. The model allows airlines to function as business enterprises and to raise private equity capital from both domestic and foreign investors while the government preserves its controlling ownership. State-owned airlines, as a result, have gone through major ownership restructure during this phase of the reforms. In addition, the industry competition has intensified as a result of a CAAC policy shift in 2004 that allows privately owned air carriers to join the industry, which, in turn, has dramatically expedited the pace for craft expansion and modernization.

In spite of the dramatic reforms noted above, SOEs remain the dominating force in the airline industry as in many other industries in China. Not surprisingly, the industry's double-digit growth has mainly benefitted state-owned airlines, leaving the dwarfed private carriers in the dust. Thus, it is critical for policy makers, airline managers, and investors to understand the relationship between state ownership and Chinese airline performance.

An investigation of the impact of state ownership on the performance of Chinese airlines bears both economic and strategic significance especially in consideration of the ever-increasing dominance the Chinese airline industry exerts in the global arena. The insight should guide the Chinese government in formulating effective policies to further liberalize the financial system, promote the industry, and tackle industry induced environmental and natural resources challenges. The knowledge can also help airline managers and investors to develop worthwhile business plans and rewarding investment strategies, respectively. In light of this, this study intends to provide more insight into the relationship between state ownership and firm performance by examining how state ownership affects the performance of publicly traded Chinese airlines. This paper enriches the existing literature in three main directions.

First, this study fills a void of the hospitality financial literature. While the rapid growth of the airline industry and the scope of recent aviation reform have spurred some financial empirical work in the hospitality sector, this study serves as the first attempt at looking into the impact of state ownership on the performance of the Chinese airline industry. Second, this research, following [Vining and Boardman \(1992\)](#), [Xu and Wang \(1999\)](#), and [Dewenter and Malatesta \(2001\)](#), adopts multiple indicators, profitability, market performance, solvency, and operating efficiency, for the performance measure. Third, this paper uses panel regression tests to investigate the impact of state ownership on Chinese airline performance. [Hsiao \(1986\)](#) and [Baltagi \(2001\)](#) favor panel data methodology for its ability to address estimation bias, heterogeneity, and multicollinearity while accounting for the time-varying relationship between dependent and independent variables. To guard against potential bias from performing panel regression tests, the study considers three estimation methods: fixed effects, pooled ordinary least square (OLS) regression, and random effects.

The rest of the paper is organized as follows. Section 2 provides literature review. Section 3 describes data and methodology. Section 4 presents empirical findings. Section 5 concludes this study.

2. Literature review

[Estrin and Perotin \(1991\)](#) contend that state firms will not focus on profit maximization due to noneconomic agenda of the state, which, in turn, will yield inferior performance. [Shleifer and Vishny \(1994\)](#) reiterate that governmental pursuit of political objectives such as bribes, excess employment, and product/service underpricing can undercut public enterprise efficiency. [Shleifer and Vishny \(1998\)](#) further propose that state firms be privatized to fight off a “grabbing hand” government. Their proposal, as claimed, should eliminate the government's practice of extorting firms for the benefit of bureaucrats and politicians and nullify the adverse impact it imposes on the economy.

[Xu and Wang \(1999\)](#), probing the relation between firm performance and state ownership of Chinese listed companies during 1995–1996, argue that state ownership creates agency conflicts and drives down firm performance and labor productivity. [Qi et al. \(2000\)](#), [Bai, Liu, Lu, Song, and Zhang \(2004\)](#), and [Li et al. \(2009\)](#) investigate the effect of ownership structure on the performance of listed Chinese firms and conclude that firm performance is negatively related to the proportion of shares owned by the state.

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