

Pros and Cons of Government Game Permit in China

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Abstract. Since 2006, the market share of Korea-made games in China has decreased, and recently Korean game companies even began to withdraw from the Chinese market one by one. It is alleged that attractiveness of the market is lessened by the Chinese government's game policy. This paper examines influence of the policy on imported online games in China, analyzing how the market condition has been changed by the policy and examining whether the policy has sufficient flexibility to cope with rapid development of the game industry and the dynamics of the game market in China. In particular, the research examines the relationship between individual Chinese game policies and performance of Korean online games in China in terms of three stages of market entry: contracting stage, beta-test stage and operating stage.

According to interview analysis of four major Korean online game firms, high entry barrier and unfavorable importation permit policy are the major reasons for decrease of the market share of Korean games in Chinese market. In the contracting stage, it is supposed that the policy of prohibiting wholly-owned subsidiaries maybe one of major reasons for decrease of the market share of imported games. In the beta-test stage, time delay due to publication permit of imported games, which has been segregated from domestic products, results in shrinking the market share in China. In the operating stage, repeated permit acquisition maybe one of major reasons for withdrawal from the Chinese market. In addition, the policy has indirectly supported domestic game firms to become huge global publishers which command local development studios. Thus, imported games gradually lost their market shares. Interviewers agree that the possible reasons for decrease of export volumes and retreat of Korean companies from Chinese market are not only the policy but also the uncertainty of the policies' changes. In addition, low degree of transparency and obscure executive standard of government regulation are other reasons.

Keywords: Chinese game policy, Korean game companies, Chinese game publishers, online game industry, market entry, import games, wholly-owned subsidiary, publication permit

1. Introduction

Almost all Korean game companies have had business relationship with Chinese companies since beginning of the Chinese game industry. However, lately Korean game companies have been troubled in the Chinese market. As noted in Tab. 1, last decade Korean games' market share in China has gradually decreased from 100% in 2001 to 26% in 2010.

Tab. 1. Korean online games' market share in China during 2001-2010*

(Unit: USD million, number)

Year	Sales Revenues		
	Total games (A)	Korean Games(B)	Market share (B/A)
2001	37	37	100%
2002	109	101	95%

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2003	170	90	54.1%
2004	255	125	51%
2005	403	160	45%
2006	623	180	35.7%
2007	1550	300	16%
2008	2650	265	10%
2009	3700	902	25.6%
2010	4670	119	26%

*Sources: White paper on Korean games 2002,2003,2004,2005,2006,2007,2008,2009

Korea's top online game makers, **NCsoft**, and others have seen their market shares keep falling in China. What's more, since 2006 some big Korean game companies such as **CJ Internet**, **Wemade**, **Webzen** and **NHN** have begun to pull their subsidiaries out of the Chinese market by selling their equities of joint ventures to local companies [1]. Market watchers pointed out that the main hurdle to Korean companies was the Chinese government's move to protect its game industry [2]. *"With the market rapidly growing, the Chinese government started to protect its game industry through regulations, putting the Korean online game firms at a disadvantage. ... The Chinese government has prolonged the process of issuing permits to Korean online-game firms and made it difficult for them to set up wholly owned subsidiaries, forcing them to establish partnerships to operate there."* Daewoo Securities analyst Kim Chang-kwean wrote. Kang Lok-hee, a senior analyst at Daishin Securities, echoed Kim's view. *"The rule helps foster the Chinese game industry because Chinese firms easily acquire technology through tie-ups."* Korean companies are increasingly faced with stiff competition from local players [3]. However, the allegation that it is just the government policy that reduces attractiveness of the Chinese market has not been proved. Is the regulatory policy really another "Great Wall" to foreign companies or just a good excuse to foreign game companies that produce unsuccessful results in China?

The above questions are not clearly answered. More important questions that how the policy influences the industry, and which policy affects foreign companies severely are not analyzed. There have been few academic studies of how national policies and regulations affect the online game industry, not to mention the influence on foreign companies. The lack of academic research is unusual, considering the plethora of studies focusing on regulation of the Internet, traditional media, and other entertainment industries ([4], [5], [6], [7]). In this context, this paper investigates how the policy influences activities of foreign online game companies in China and whether the policy on the game industry in China is the major reason for decrease of the market share of imported online games including Korean products.

2. Government policy on imported games

In the past few years, China has promulgated a series of regulations that governs the online game industry. The main policy on foreign game companies and imported games can be divided into three kinds: restriction on a wholly-owned subsidiary (WOS), governmental permit and control on contents.

2.1 Restriction on wholly-owned subsidiary

Foreign direct investment in telecommunications companies in China is regulated by the *Regulations for the Administration of Foreign-Invested Telecommunications Enterprises* (外商投资电信企业管理规定) (the FITE Regulations), which were issued by the People's Republic of China (PRC) State Council on December 11, 2001. The FITE Regulations stipulate that telecommunications enterprises in China owned by foreign investors (so called, FITEs) must be established as Sino-foreign

equity joint ventures. Under the FITE Regulations and in accordance with WTO-related agreements, the foreign party of an FITE engaging in value-added telecommunications services cannot hold majority ownership i.e., more than 50% equity of the FITE. Since the game publishing industry provides value-added telecommunications services, wholly-owned foreign publishers are forbidden to be established in China. It means that foreign companies which want to provide game publishing services in China cannot hold a majority partnership at a joint venture with Chinese partners,.

On June 3, 2010, the Ministry of Culture (MOC) promulgated the *Interim Measures on the Administration of Online Games*(网络游戏管理暂行办法). It is the newest policy of reinforcing entry barriers. The Measures which ask additional requirements to foreign game publishers heighten the entry barrier. The target of the Measures is foreign subsidiaries borrowing a Chinese company's name to publish games. Korean game companies used this by-pass method to get sole control of joint ventures often, but now, it's more difficult to get around the regulation on the WOS.

- Impact on foreign firms before 2005

Because of the limited equity position, Korean companies that want to publish games in China have to cooperate with Chinese local game companies in a form of joint ventures or license contracts. For joint ventures, Korean companies can have equities less than 50% by law and a few Korean companies have set up joint ventures with Chinese partners. Most of Korean companies made license contract agreements with Chinese publishers.

But historically, most of early Korean-Chinese cooperation cases produced undesirable results, such as the **Shanda-Actoz** case (Lee, 2004). The undesirable results were expected when Korean games were published by Chinese publishers in the market where piracy was rampant and protection mechanism was not fully equipped. It means that transaction costs resulting from contract agreement with partners were so high that Korean game firms should have chosen the WOS entry mode, but because of the entry barrier regulation, it was not a feasible option.

The transaction cost analysis (TCA) predicts such historical lessons. The TCA can help explain choice of the entry modes of the international business: license, wholly-owned subsidiary and joint venture ([8], [9], [10]). The TCA asserts that potential threat for opportunistic behavior of the partners is most likely when an exchange requires one or both parties to make significant transaction-specific investment. It is because such investment creates quasi-rents that are subject to the hold-up problem. The WOS is better choice when uncertainty and high asset specificity lead to transactional difficulties.

- Impact on foreign firms after 2005

Under the government protection for the game publishing industry, Chinese game publishers have been bigger and more powerful, and constitute oligopolistic structure in the market. Korean game developers have been changed into inferior position in the trade with strong Chinese publishers. From 2001-2005, as for license trades between Korean game developers and Chinese game publishers, it was sellers' market, but since 2005 when Chinese game publishers get stronger, the situation began to change. Now, it has completely changed to buyers' market. Most Korean game developers are unwillingly making license agreement with Chinese publisher to enter Chinese market. When so many Korean developers struggle to make contract with a few strong Chinese publishers, license royalty fee would be lower and licensing condition would be unfavorable to the former.

2.2 Publication permits for imported games

The General Administration of Press and Publication (GAPP) is the authorities responsible for examining and approving games from the publication perspective. The GAPP promulgated the Electronic Publication Rule in 1998, which regulated whole game publishing industry. The rule was reinforced by the updated Electronic Publication Rule in 2008 which impacted on imported online games. The new Electronic Publication Rule regulates the production, publishing and importation of electronic publication in China, and outlines a licensing system involving electronic publishing. Under

them, a Chinese company must obtain the importation permit of the GAPP to publish foreign electronic publications. The MOC also requires a similar kind of approval process. Foreign developers, which intend to export online games through their exclusive local distributors, should file an application with the MOC and must present required materials including their Internet Cultural Operation Permit.

Publishing permits of imported online games issued by two governmental agencies are not easy to get. It is more difficult for imported games to get permits than home-made games. In quantity, every year only 10-30 imported games can get the permits while the number of approved domestic games reaches 176 in 2010 as shown in Tab. 2. What's more, because it's not a quota-based system, the evaluation criteria or required level of imported games that can get the permits is difficult to be predicted. In addition, it takes at least more than 5 months to get the permit.

Tab. 2. Number of games obtaining the Internet Cultural Operation License* (Unit: number)

Year	Domestic games	Imported games
2004	7	33
2005	19	17
2006	24	26
2007	23	10
2008	19	29
2009	80	23
2010	176	28

* Source: official website of MOC [11]

In addition, the *Announcement on Regulating Applications for Contents Censorship for Imported Online Games*(文化部关于规范进口网络游戏产品内容审查申报工作的公告) enforces imported games to go through contents approval the only after the games are fully developed. Due to this policy, one way to shortening time by filing the applications before fully developed is completely blocked.

- Direct impact on imported games

Quantitative limitation of issuing permits is a way to protect home-made games from beaten by imported games in competition. There is also another problem caused by the government permit policy indirectly. Only a few big local game publishers who have good relationship with government agencies have a possibility of acquiring the permits for imported games successfully. In the situation, they may exercise superior power when so many international developers struggle to make contract with them. It is another entry barrier to foreign game companies, especially small and medium-sized developers. Foreign game companies are powerless and frustrated, and often decide not to publish games in the Chinese market.

- Indirect impact on imported games

Two problems also arise during the beta-test stage, indirectly. First, as mentioned above, governmental permits may cause unequal power balance between partners. Even after the contract signed, Chinese publishers may still exercise superior power during the whole game beta-test stage. Online game service is a process that developers and publishers work together consistently. The unequal partner's power between Korean developers and Chinese publishers may cause adverse effects on game operation. Second, time delay due to long approval process can cause other problems. Most importantly, during the waiting time, illegal copy of the game may be developed and launched by local game companies earlier than the original. And next, although there is no piracy, the time delay may lose the best time to launch the game, making popular contents obsolete.

As the permit approval process changed to be a complex and time-phased process, only big Korean game developers may pass over the hindrances. For small and medium-sized game companies,

it will be harder to enter Chinese market. Therefore, it seems that in the Korea-Chinese trade market, only a few big Korean and Chinese game companies would be left.

2.3 Update permits for imported games

The *Announcement on Regulating Applications for Contents Censorship for Imported Online Games* (文化部关于规范进口网络游戏产品内容审查申报工作的公告) reinforced imported game control in a way that previously approved imported online games must undergo permit application procedure again if new versions and new materials of the games are updated. If new versions are updated or important contents are materially altered, new proposed contents must be submitted to and approved by the MOC and the GAPP beforehand.

- Impact on imported games

When the content of an imported online game is materially altered, the new proposed contents must be submitted to the MOC for contents censorship. In this case, the GAPP also requires approval of the proposed changes beforehand. In order to keep gamers’ popularity and draw new attraction, game contents should be updated constantly. High costs and time delay incurred from repeated update approval are an additional operation barrier to foreign game companies. Recently, due to this approval system, **Blizzard** and **NetEase** finally were able to launch *Wrath of the Lich King*, the new version for *World of Warcraft* in China on August 31, 2010, after about 7 months delay. The delay was due to the contents review process.

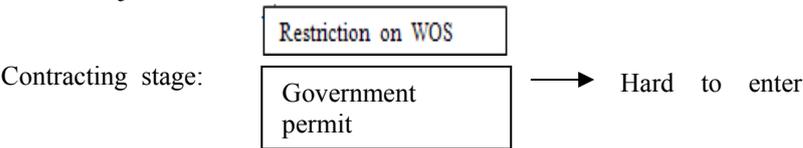
2.4 Control on contents

Every country has regulations which control or prohibit some inappropriate contents such that harm national sovereignty, call into question the territorial integrity of the country, divulge State secrets, promote cults, and use obscenity or pornographic images, etc. China also has very strong regulations for control on contents. Majority of contents prohibitions focus on protection of minors. Online games intended for minors must not contain contents which encourage minors to imitate criminal behavior. Contents involving horror or cruelty which could impair physical and mental well-being of minors are also prohibited. In addition to hostility between players, any kinds of gambling by using virtual currency or legal tender are completely restricted to all players.

Since the contents regulations are embedded in almost all level of laws including the Constitution of China, it is not easy to pinpoint specific rules. Nevertheless, it is argued that Chinese control and restrictions on contents are very broadly and in some cases, ambiguously defined and above all, interpretations of the rules are strict and arbitrary. Some contents which are accepted in Korea or US cannot be published in China. For example, in the past *Command & Conquer: Generals - Zero Hour*, a game simulating war, was previously banned for smearing the image of the Chinese army [12]. It is believed that the contents restrictions cut the attractiveness of imported games; however it is not easy to measure the impact on imported games.

2.5 Summary of policies impacts on imported games

Considering the influence of governmental policies on foreign games or companies reviewed in the previous chapters, the phenomena of decreasing foreign games’ market share in China can be analyzed in terms of three stages as shown in Fig 1: contracting stage, beta-test stage and operating stage. First, in the contracting stage, it is supposed that high entry barrier maybe one of main reasons for decreasing Korean games’ share in the Chinese market. Second, in the beta-test stage, it is supposed that diminishing game attractiveness resulting from contents control and imported permits maybe one of the major reasons. Third, in the operating stage, it is supposed that update permit maybe one of the major reasons.



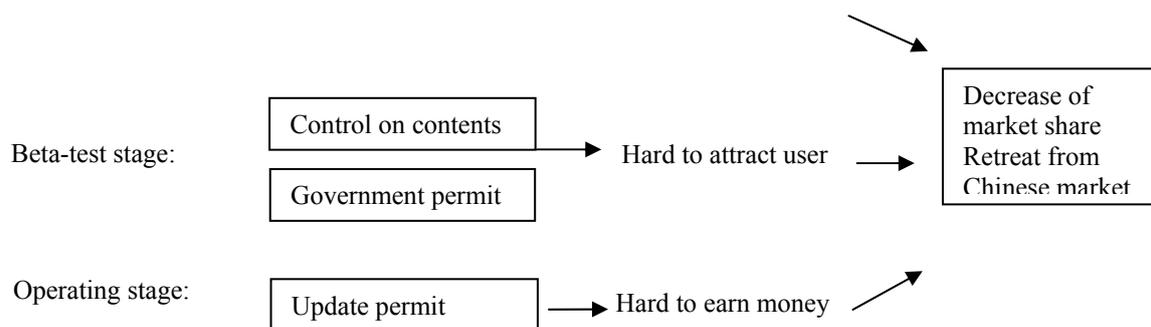


Fig. 1. The relationship between policies and Korean games during three stages

3. Interview design and result

3.1 Selection criteria of objects

Well-known Korean online game publishers and developers, such as **NCSOFT**, **Neowiz Games**, **Nexon**, **NHN-Hangame**, **CJ Internet** and **Wemade** have targeted Chinese markets as a top priority. Their entry modes are not the same and achievement in Chinese market are also different. Until now, some of them have got big success, some of them have withdrawn their offices with lessons of unsuccessful results and some of them still remain with mediocre performance. In this research four large companies among which two of them got big success and other two dissolved joint ventures for some reasons were chosen as the sample of analysis. Profiles of the sample firms are as shown in Tab. 3.

Tab. 3. Profiles of the sample firms*

(Unit: USD million)

Company	Founding year	Time of entering China	Entry mode	Publishing partners in China	Sales of 2010 Chinese market/Total
AA	1994	2003	License/ Joint venture(remain)	Tencent, Shanda	189/ 460.2
BBB	1998	2004	License/ Joint venture(retreated)	Tencent	90/ 265
CCC	1998	2003	License	Tencent	210/ 387.6
DDD	1997	2004	License/ Joint venture(retreated)	Tian City	63/ 190.1

* Source: Companies Annual Report, interviews

During June 2011, four interviews were conducted with managers in Korean online game companies who had rich experiences on Chinese market. Total collective experience of the interviewees is 48 man/years. These managers had direct responsibility for Chinese market operations. The interviews typically lasted about two hours.

3.2 Findings

3.2.1 The contracting stage

All the interviewees agreed that entry barriers were the main hindrance for Korean game companies to lose profitable chances. Profit resulting from game operation would be much higher if wholly-owned subsidiaries were allowed to publish their own games in the Chinese market.

Tentatively not considering the profit, the most worrisome issues of Korean developers are the leakage of technology. Under either the license model or joint venture model of Sino-Korean cooperation, Korean companies provide technology while Chinese companies do the game operation. In the both kinds of structures game developing technology is easy to transfer without notice. *“If we develop a game spending 3-4 years and send the game codes to our Chinese publishing partner, our partner can make a similar game in 3-4 month.”* The director of AAA said. *“These kinds of examples are a lot, Sanda developed a game that had a similar design and story line to Mir 1 very quickly while it published Mir 1 developed by Wemade.”* *“Joint venture model will never be successful and there is no successful case, none.”* Said the director of DDD. *“We want to enter Chinese market, but there is no choice for entry mode”* he added.

3.2.2 The beta-test stage

All the interviewees expressed that compared with the restriction on the WOS, government permit approval was more troublesome. *“It’s very hard to get,”* said the director of CCC, *“Blizzard waited for half a year, suffering from heavy losses, but which game developers are as strong as Blizzard?”* The director of BBB told that because of time delay of approval, they began to contract with Chinese publishers in advance, *“we start the negotiation of license contract although games are still on the developing stage; we try to shorten the contract time in order to reduce the opportunity cost of time delay of approval.”* However, since a very recent new rule (2010) prohibits the permit application of work-in-process games, the director’s wisdom is no more useful.

All of them complain that time delay problems due to long and uncertain permit approval process really cause piracy and miss the best time to launch games, change the popular contents into obsolete ones. They said that if the license approval is just one time they could bear. However, since the update permit rule was reinforced in 2009, they should repeat the process again when the games are updated and new materials are added. The new rule makes them feel more frustrated in publishing at the Chinese market.

But some interviewees argue that the above complaints were true reasons for decreasing sales several years ago but the situation is changed. At present, as Chinese game industry developed, they make games that match Chinese users’ taste better than foreign game developers do. Chinese local games’ competitiveness would be more plausible reasons why imported games cannot attract Chinese users any more except several killer games such as *Crossfire*.

3.2.3 The operating stage

Contents restriction has little negative impact on the contents attractiveness. All the countries have contents restriction policies for protecting minors from contents of negative influence. China is no exception in this matter. Content containing horror or cruelty is prohibited. The interviewees agreed that although it is buyers’ market in the trade between Korean game developers and Chinese game publishers now, for a few competitive products, the Chinese publishers may be vying with each other for the chance to license the possible hot games. In this situation, Korean game developers may demand high royalties and other payments. In other words, there is no absolute distinction of sellers’ market or buyers’ market.

3.3 Summary of findings

It is found that impacts of Chinese government policies on Korean online games business can be shown as Tab. 5.

Tab. 5. Policies impacts on Korean games during the three stages

Governmental Policies			
Restriction on WOS	Government permit	Update permit	Contents control

Contracting stage	●	◎	◎	—
Beta-test stage	—	●	◎	—
Operating stage	—	◎	●	—

● strong influence ◎ some influence — No influence

On the policy perspective, it is concluded that the entry barrier policy under which foreign online game companies ought to choose cooperative entry modes, either licensing or joint venture models gave influence on Korean game companies in the early stage of Chinese game market development. Second, it is shown that the government permits policy impacts all the three stages. This policy is considered as the most intractable one by almost all the Korean companies entering China. Difficulties of acquiring original importation permits strongly influence in the beta-test stage while repeated application of update permits directly influences the operating stage. Especially, quantitative limitation of permits issued every year, time delay of approval, and unequal power balance between partners influence all the three stages. Third, for the policy of control on contents, it is found that the policy has no relationship with decreasing share of Korean games in the Chinese market.

The interviewees all agree that the possible reasons for decreasing number of Korean games and withdrawal of Chinese business are due to not only the policies themselves but also the uncertainty of the policies' change. In addition, low degree of transparency and the obscure executive standard of government regulation are other reasons. Korean game companies feel uncertain in Chinese market. *"If the governmental policies have clear and certain standards, we can just accord with them, but the policies themselves are uncertain and unconfirmed. Especially, in execution there is no clue,"* said the director of AAA. *"The government always sends us a signal that 'be careful, I can drown you out at any time'; all the Korean companies have this feeling,"* he added.

4. Implication to Chinese game industry

4.1 Chinese publishers

With the rapid growth of Chinese online game market, China is definitely an appealing target market for foreign online game publishers. Under the entry barrier policy, Chinese online game companies are protected without severe competition with international publishers. Leveraging rapid growing Chinese gamers, they being listed at NASDAQ or Hong Kong stock market, raise huge funds internationally. It can be concluded that the Chinese policy for the last decade provide a firm basis to have nurtured game companies into present worldwide scale publishers. Having world-wide publishers, Chinese online game industry can expand its territory into Japan, US and even Korea.

However, oligopolistic structure of Chinese publishers formed by *Shanda, Tencent, Netease*, etc may produce harmful effect on industrial development and game service innovation. They may not want drastic changes which break up the current position. A good eco-system is one which has a lot of new innovative start-ups. However, with stalled industrial structure, it is not easy to form an eco-system for nurturing start-ups which provide the industry with creativeness and innovation.

4.2 Chinese game developers

Since the success of an online game depends on contents that appeal to players' cultural backgrounds, Chinese developers enjoy an automatic advantage of having historical stories or martial art contents as game storylines at home and in neighboring Asian countries which China has historically influenced on. However, Chinese developers have to go a long way before they overtake their Korean rivals in terms of game design and innovative technology. Chinese companies will catch up quickly in the area of casual games since those are easy to absorb technology. But for MMORPG, there is still a few years' gap. Chinese developers' prowess is increasing so fast that it is not sure for Korean and other foreign developers to enjoy comfortable earnings for years to come.

However, situation of developers positioning at the value-chine is not favorable at all. With growth of super game publishers in the Chinese market, the center of gravity between publishers and developers slants toward the former heavily. The developers are monitored and controlled by the big publishers through equity acquisition or contract relationship. They are easily trapped into comfort zones where they have stable working environment with steady orders from related publishers in some way. The game development industry belongs to creative industry. The driving power of creativity sometimes comes from the pressure for survival. Staying as a dependent of a super-rich publisher, living without worrying about food and clothing, the developers' creativity of game development will be killed. These well-off game studios can be outstripped by foreign competitors little by little. A good ecological system for online game industry must improve levels of all the players in game industry, including game developers as well as game publishers.

4.3 Chinese controlling agencies

According to Ernkvist and Ström (2008), the stance of the Chinese government toward online games has been influenced by three aspects of state policy: (a) techno-nationalism, (b) information control, and (c) pragmatic nationalism and social concerns [13]. The government permit system satisfies all the aspects. First, it can provide advantage of time-to-market to domestic game developers through prolonging imported game permit process. In other words, the policy gives a chance for domestic game developers to reverse-engineer imported games. Second, it can monitor the quality and filter the contents of imported games beforehand so that Chinese gamers can be protected by arbitrary foreign influence. Besides, adjusting the amount of imported games as well as facilitating development of home-made games, the goal of pragmatic nationalism and social concerns is attained.

The online game industry is not only a technology integration industry but also a trend integration industry, or a cultural industry. So, if the restrictions on foreign games are too tight, the exchange of new concept, new technology and new trends will be bogged down. It works against the growth of local online game industry in a long term. In all, one of China's weaknesses is lack of creativity. Because of some cultural, historical and political reasons, various aspects of the Chinese market, industries and even sociality are short of creativity. "Creative industries" are a quite recent category in academic, policy and industry discourse. They can claim to capture significant 'new economy' [14]. How the governmental policies facilitate unfolding mechanism of creativity is an important issue.

Ironically, China doesn't have a rating system for online games yet. Considering the high proportion of minors, regulatory regime including the rating system should have been much more stringent than now.

4.4 Chinese game consumer

For Chinese online game users, only being familiar with localized game products is not only a block of cultural diversity, but is also not propitious for further expansion of national creativity. The online game publishing sector creates the service through interaction with users, or rather, co-production with users. Users' level grows up with the heightening of the game quality. If the users' game comprehension and game playing capacities are diminished by the limited game products, it will work against the long term growth of local online game industry.

4.5 Research limitations and future research

This research has several limitations to propose clean arguments. The major limitation comes from the research methodology. The study used the interview method with a limited sample size. Second, the sample firms have had different experiences. It can be conjectured that opinions of directors having experienced failure in China would be different from those of successful firm. Third, the interview objects are limited to Korean firms only. If another four interviews would be done with directors of overseas game operation division from Chinese publishers, there would be different

perspectives. However, it seems that this study provides at least some insights into strategic directions of Korean game companies in Chinese market.

In future research on relationship studies between governmental policies and foreign companies entering Chinese market, more attention should be given. It all depends on the timeliness to evaluate whether a governmental policy has been successful or failed, or whether it has facilitated or hindered the development of a certain industry. For an instance of Korean movie industry, there were also governmental protection policies called “screen quota” system under which certain number of foreign movies can be played once. From when to when the protection policy should be practiced, and from when it should be revoked, is the most important governmental decision for the development of Chinese online game industry.

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