The Lowdown on Customer Loyalty Programs: Which Are the Most Effective and Why

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When making a purchase, a consumer has a choice between using frequent-flier miles, cash, or some combination thereof. Which will he or she choose? Another consumer has an opportunity to participate in a special program to get a free car wash after paying for a certain number of washes. What's the best way for the car-wash owner to motivate the customer to participate?

Such questions are serious business for airlines, hotel chains, credit-card companies and other corporations that offer loyalty programs to customers. Wharton marketing professor Xavier Drèze and Joseph C. Nunes of the University of Southern California's Marshall School of Business have spent several years studying these programs and have reached a number of conclusions as to how they can be structured to generate the most revenue for companies that offer them.

Loyalty programs have been around for more than 100 years and are experiencing an enormous resurgence, according to Nunes. Frequent-flier programs are among the best-known -- American Airlines is credited with launching the first in 1981 -- but companies began trying to win the hearts and minds of customers long before that. One of the early efforts to encourage customer loyalty was the S&H Green Stamps program, which began in the 1930s. Consumers received tiny stamps when they made purchases from participating merchants, glued them onto pages of booklets, and redeemed them for products when the accumulated stamps -- a form of "alternative currency" -- had attained a certain value.

"Trading stamps of all kinds are often seen as the first alternative currency to be awarded to encourage repeat purchases," Nunes notes. "They were initially awarded to customers who paid with cash instead of credit in the 1800s, but evolved into something given out with purchases. After World War II, dozens of companies began trying to outdo each other, offering double, triple and ultimately quadruple stamps. The escalation ultimately led to the stamps' demise. By the mid-'60s, supermarkets started offering straight discounts instead to cut out the middleman."

According to Jupiter Research, more than 75% of consumers today have at least one loyalty card, and the number of people with two or more is estimated to be one-third of the shopping population. Surveys by information-technology analysts Gartner, Forrester Research and META Group suggest the data-for-dollars explosion is showing no signs of letting up anytime soon. According to Gartner analyst Adam Sarner, U.S. companies spent more than $1.2 billion on customer loyalty programs in 2003.

Drèze and Nunes became interested in loyalty programs after suspecting that many of them were not performing as well as they could for the corporations promoting them. "There are a lot of ineffective programs out there," Drèze says. "To distinguish a good one from a bad one you have to understand how they motivate people. There hasn't been that much research on the underlying principles that make a loyalty program work or not work for a firm. We felt that was a significant gap that needed to be filled."

Dollars and Miles

In a paper titled, "Using Combined-Currency Prices to Lower Consumers' Perceived Cost," Drèze and Nunes examine the different kinds of currencies that consumers can accumulate and spend, such as frequent-flyer miles and hotel and credit-card rewards points. As consumers are increasingly able to pay for a variety of goods and services using a combination of reward currencies and real money, how they respond to what Drèze and Nunes call "combined-currency" transactions has become important to marketers.

In their paper, Drèze and Nunes present a mathematical proof that outlines the conditions under which a price delineated in multiple currencies (for instance, $39 plus 16,000 miles) can be superior to a standard, single-currency price (where a person pays either $189 or 25,000 miles but not a combination of the two).

In the paper, published in 2004 in the *Journal of Marketing Research*, Drèze and Nunes say there are two ways that combined-currency pricing can bring in more revenue for a company: such pricing can either lower the psychological or perceived cost associated with the pricing scheme or raise the amount of revenue collected given a perceived cost.

For example, a consumer may be indifferent as to whether he spends $500 or 25,000 miles on an airline ticket, but prefers paying $400 plus 5,000 miles rather than paying either of the single-currency alternatives. "At $0.02 per mile, the combined-currency price brings in the equivalent revenue to the airline, yet inflicts a smaller psychological cost to the consumer," the researchers write.

It is important to note, they add, that this consumer's preference for the combined-currency price indicates that each mile or dollar spent is not valued equally. The perceived cost of paying more dollars and/or miles increases as the payment in that currency increases. As a result, it will be best for a company to charge a combined-currency price for, say, an airline ticket when two conditions exist: The consumer does not value each unit within a currency equally and the perceived cost function for one of the currencies is said to be "convex." Convexity means, for example, that 25,000 miles appears to be worth more to the consumer than twice as much as 12,500. Why? "Twenty-five thousand miles will get you a free round-trip ticket within the United States, while 12,500 miles might only get you an upgrade," says Drèze.

The authors reached their conclusions after surveying three groups of travelers and having them evaluate and make choices among prices issued in single and combined currencies. The authors say their research is the first to explore how consumers evaluate transactions involving combined-currency prices.

"You would think that if people were offered money and miles, they would always take the money, but a lot of people want the miles instead," Dreze says. "Their feeling is, 'Money is only money and if I take money instead of miles, I'll just use the money to pay a bill.' There's nothing special about paying a bill. But when they take frequent-filer miles as a reward instead of cash, they will use them to take trips and that gives them memories. That makes the miles special. The airlines consider their programs 'aspirational' as fliers earmark their miles for special trips. There's a lot going on psychologically when it comes to taking miles or some other kind of rewards points. People don't consider miles or points to be the same thing as money."

"Artificial Advancement"

In another paper, "The Endowed Progress Effect: How Artificial Advancement Increases Effort," Nunes and Drèze outline how companies can structure certain rewards programs to make them more attractive to customers and hence more profitable. Endowed progress means that people who are provided with artificial advancement toward a goal show greater persistence towards reaching the goal than they otherwise would. By artificial advancement, a company advances a customer toward a goal while simultaneously moving the goal further away, so that the task requirements and the reward remain unchanged.

For example, a company could improve a rewards program that requires eight purchases in order to earn a specific reward by revamping it so that the program requires 10 purchases, but with two awarded upon enrollment. Both programs require eight purchases and provide the same reward, but customers are more apt to complete the program -- and complete it sooner -- if they are given a head start, according to the paper, which was published this year in the *Journal of Consumer Research*. The authors demonstrated this through an experiment involving 300 customers of a car wash who received loyalty cards and whose subsequent visits to the car wash were tracked.

"By converting a task requiring eight steps into a task requiring 10 steps, but with two already complete, the task is reframed as one that has been undertaken and incomplete rather than not yet begun," according to the study. "This increases the likelihood of task completion and decreases completion time."

In addition to the study of the behavior of the car-wash customers, Drèze and Nunes conducted four other studies of consumers for their paper on the endowed progress effect. They found, first, that as people progress toward a goal, their effort will increase and thus completion time will decrease. Endowed progress, which provides artificial advancement towards the goal, exacerbates this effect. Second, the researchers learned that persistence depends on relative progress made by a person, not on the amount of reward points or miles that would be lost by failing to continue.

Third, when the endowed progress is issued in points rather than purchases, both the endowment and the return that customers obtain for their efforts appear more significant and thus customers will exert more effort. Finally, Nunes and Drèze learned that the endowed progress effect is more likely to operate when consumers are provided with a reason for the endowment, even if that reason is specious -- such as, "Our company is considering a rewards program; would you like to participate?"

Programs on the Increase

Loyalty programs continue to grow. "Even Neutrogena is planning to roll one out, and the NBA [National Basketball Association] is looking at starting one too," says Nunes. "Loyalty programs used to be used chiefly in service businesses like credit cards, hotels and airlines. Those businesses with inventories of perishable products or services, like hotel rooms and seats on planes, had little costs and lots to gain from getting into this. Credit cards just used miles as a payback: you collect 3% from vendors and give 1% back. But now, to remain competitive, all kinds of companies are doing it. Heck, Maxwell House coffee has its own program where consumers earn 'House Points' with each can they buy."

Nunes says some consumers get excited about amassing points even if the points have no currency value. "Yahoo Answers, a question-and-answer site run by Yahoo, gives points to users who answer questions and rate the questions and answers of others," he says. "You can't exchange these points for real-world goods and services, yet people still spend enormous amounts of time accumulating them just to beat others in a list of top point-getters, or simply to compete with themselves."

Loyalty programs can be quite effective. In a study, "Exploiting the Installed Base Using Cross-Merchandising and Category Destination Programs," that Drèze conducted with Wharton marketing professor Stephen Hoch, a "baby club" loyalty program increased sales of baby products by 25% on average over a six-month period. It did that by increasing the number of transactions with baby products. It also increased the amounts purchased in each transaction and boosted store traffic by 5%.

But Nunes points out that the long-term impact of loyalty programs is not yet completely understood. For instance, an online study by Maritz, a market research and consumer loyalty program consulting and implementation company, found that members of programs spend more. But it was unknown whether the program drives spending or whether big spenders are just more prone to join programs and get rewards for their spending. Nunes suspects the latter, and worries that "some firms are simply bidding for the best customers by offering them bigger and better rewards."

Loyalty programs, he adds, "need to be designed to offer differentiated products and services to customers based on their purchasing patterns and profitability. If these programs are simply based on quantity discounts or paying for patronage, they will not endure."

Drèze and Nunes are continuing their research into loyalty programs. Among other issues, they are currently exploring the use and effectiveness of "status" -- gold cards, platinum cards and the like -- in loyalty programs. "A lot of loyalty programs endow customers with status, which they earn through purchases or other actions," Nunes explains. "Our research is looking into how stratifying customers and endowing some with status makes them feel different and thus behave differently."

The researchers have just begun investigating the topic. But from what they have discovered so far, it appears that assigning a customer to a category -- such as gold status -- may put them in the top 5% of all customers but it does not necessarily make the customer feel special. It turns out that gold customers feel much more distinctive and apt to spend more if they know that there is another class of people -- those endowed with 'silver' status, for instance -- below them. This paper is tentatively titled, "A Cut Above: Exclusivity and Status in Consumer Loyalty Programs."

"If you go back 10 or 15 years, a gold card was really special," Drèze says. "Today, if you don't have a platinum card, which confers greater status than gold, you're nobody. The interesting thing is that what has evolved over time is that more and more customers need status. Marketers need to find ways to separate one class of customer from another."