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Understanding the Effectiveness of Loyalty Programs

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Report Summary

Loyalty programs are popular and ubiquitous marketing instruments, with U.S. companies spending more than \$1.2 billion on them each year, program participation topping 1.8 billion, and the average U.S. household subscribing to 14 different programs. Yet, many loyalty programs perform poorly, often resulting in their abolition. To both marketing managers and researchers, the reasons for loyalty program failure remain unclear.

Lena Steinhoff and Robert Palmatier propose that greater understanding of loyalty program effectiveness demands a broader framework for analyzing loyalty program performance, along three key perspectives. A *customer portfolio* perspective can indicate the loyalty program's opposing effects on target versus bystander customers; a *reward element* perspective delineates the varying efficacy of its different reward benefits; and a *reward delivery* perspective highlights how reward delivery either emphasizes or diminishes the program's effects.

Customer gratitude, status, and unfairness represent positive and negative forces, mediating the loyalty program's impact on performance outcomes.

In three studies—two experimental and one field—the authors empirically investigate their evaluative framework. Results provide important insights for managers of loyalty programs.

First, findings underscore the importance of a customer portfolio perspective. For example, in an airline context with free services granted to target customers, at a ratio of 13 or more bystanders to 1 target, the bystander losses outweigh the target customer's profits.

Second, findings demonstrate the importance of a reward element perspective. For example, in a typical airline loyalty program, although free services exert a strong positive effect on target customers, they affect bystanders only slightly negatively. Priority boarding instead confronts managers with a tough trade-off: It positively affects targets but strongly negatively affects bystanders.

Third, findings reinforce the importance of a reward delivery perspective. For example, explicitly and clearly communicating the rules of a loyalty program helps decrease bystander customer perceptions of unfairness, but at the same time, it reduces the level of target customer gratitude.

Overall, these findings provide evidence for why and when loyalty programs fail. The authors conceptually and empirically establish a comprehensive analysis framework to help marketing managers and researchers evaluate loyalty program effectiveness. Using their insights, they offer managerial guidelines for delivering loyalty programs in ways that can enhance performance. Beyond, two loyalty program analysis tools which are readily applicable for and particularly beneficial to managers are outlined.

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Loyalty programs, in business practice and as a focus of marketing research, have become vastly popular, such that U.S. companies spend more than \$1.2 billion on them each year, program participation has topped 1.8 billion, and the average U.S. household subscribes to 14 different programs (Ferguson and Hlavinka 2009; Wagner, Hennig-Thurau, and Rudolph 2009). As these numbers suggest, loyalty programs “have become a key component of customer relationship management” (Kivetz and Simonson 2003, p. 454). However, their financial performance rarely meets expectations (Henderson, Beck, and Palmatier 2011), which often results in their termination (Nunes and Drèze 2006). Even Starbucks recently decided to halt its rewards program due to poor performance (Allison 2010), and Safeway ended its loyalty scheme due to its lack of effectiveness (Meyer-Waarden 2007). Although marketing researchers substantiate the efficacy of some loyalty programs (Leenheer et al. 2007; Shugan 2005), to date, “it is far from clear what sets a successful [loyalty program] apart from an unsuccessful one” (Kumar and Reinartz 2006, p. 172). In view of these mixed effects, *the focus of this research is to improve our understanding of loyalty program effectiveness.*

We propose that to understand loyalty program effectiveness, researchers and managers need to expand their evaluative framework to include perspectives on customer portfolios, reward elements, and reward delivery, which together capture unexplored, performance-relevant facets of loyalty programs. First, when evaluating loyalty program performance, a *customer portfolio perspective* can account for its effects on both target customers and any bystanders. Researchers and managers often ignore how loyalty programs targeted at one customer simultaneously and perhaps unintentionally influence other customers, the bystanders. Recall the hotel scene in the movie *Up in the Air*, in which George Clooney as a premium customer provokes the resentment of waiting customers when he skips a long line to be served instantly. Yet with the notable exception of Feinberg, Krishna, and Zhang (2002), extant studies apply solely a target customer perspective when investigating customer responses to rewards (Barone and Roy 2010). Because unfairness concerns (Samaha, Palmatier, and Dant 2011) and social comparisons (Drèze and Nunes 2009) play important roles in customer relationships though, negative bystander effects that result from perceptions of unfairness or status demotion may offset positive target customer effects, resulting in an ineffective loyalty program.

Second, using a *reward element perspective*, evaluations of loyalty program performance can account for the differential, potentially opposing effects of various reward elements. Most loyalty programs consist of multiple rewards (e.g., priority benefits, free services), yet extant research typically investigates their effectiveness at an aggregate level (Meyer-Waarden 2007). In turn, the positive and negative effects of specific reward elements on target and bystander customers may be masked. For example, granting target customers priority check-in might have a different impact on both targets and bystanders than does the provision of free services (e.g., welcome drink) in the same loyalty program context. Unless specific program reward elements are evaluated separately, misleading conclusions may result.

Third, a *reward delivery perspective* should apply in loyalty program performance evaluations, to account for the differential and potentially opposing effects of reward delivery on the links between specific reward elements and target versus bystander customers' responses. Loyalty program effectiveness is contingent on the way the rewards get delivered (Palmatier et al. 2009). However, bystander customers' reactions to observing a target receiving a reward might vary with the method for delivering the reward. For example, a bystander who is aware of the company's justification for differential customer treatment might respond differently than a bystander to whom the reward allocation seems random. If firms can control the extent to which target and bystander effects get enhanced or suppressed, then reward program delivery characteristics constitute important levers for managing loyalty program effectiveness.

To account simultaneously for the positive and negative effects of loyalty programs on performance among target and bystander customers, we include three loyalty-influencing mechanisms (gratitude, status, and unfairness) in our conceptual model. Gratitude offers an important positive mechanism, linking rewards to performance (Palmatier et al. 2009). Experiencing preferential treatment enhances the perceived status of target customers while reducing that of bystander customers (Drèze and Nunes 2009); with its inherent relativity, status thus acts as a double-edged sword, with simultaneous positive effects on target customers and negative effects on bystanders. Finally, bystanders frequently perceive unfairness (Feinberg, Krishna, and Zhang 2002). Ultimately, gratitude and enhanced status might build target customer loyalty, while reduced status and unfairness can undermine bystander customer loyalty.

We empirically test this framework in three complementary studies, applying mixed methodologies. In Studies 1 and 2, we use an experimental approach, in airline and hotel

contexts, respectively, to address the customer portfolio and reward delivery perspectives. We establish the opposing effects of loyalty programs on target and bystander customers, as contingent on reward delivery. In a customer portfolio analysis, we also show analytically that with a certain number of bystanders, firms can incur losses from their loyalty program. In Study 3, we test our conceptual model in a field setting. Across multiple airline loyalty programs, we assess the customer portfolio and reward element perspectives to provide a fine-grained view of how specific reward elements differentially affect target and bystander customers. In a reward element analysis, we demonstrate differential sales impacts.

Through these efforts, this article makes four main contributions. First, we find empirical support for the importance of taking a customer portfolio perspective that accounts simultaneously for target and bystander customers when analyzing loyalty program performance. Whereas loyalty programs increase target customers' loyalty and sales, they also decrease bystander customers' loyalty and sales. Target and bystander customer effects work in opposing directions, which might explain the ineffectiveness of many loyalty programs. For example, in an airline context with free services granted to target customers, at a ratio of 13 or more bystanders to 1 target, the bystander losses outweigh the target customer's profits. These results should help managers recognize the potential dangers of prioritizing the few at the expense of the many.

Second, we disentangle the differential effects of specific program reward elements on target and bystander customers, which can be lost when evaluations aggregate the effects of multiple elements. By empirically analyzing customer responses to typical rewards employed in airline loyalty programs, we underscore the importance of a detailed reward element perspective for making informed decisions about the introduction, adaptation, or abolition of rewards. In particular, though free services exert a strong positive effect on target customers, they affect bystanders only slightly negatively. Priority boarding instead confronts managers with a tough trade-off: It positively affects targets but strongly negatively affects bystanders. Evaluating loyalty program effectiveness at the reward level thus is key for managers to understand specific reward element effects and design efficient programs.

Third, we identify and empirically demonstrate how reward delivery characteristics differentially affect the reward–performance linkage among target and bystander customers. By showing that these effects can be enhanced or diminished, depending on the specific configuration of loyalty programs, we reinforce the importance of a reward delivery perspective.

The rule clarity and reward visibility in a loyalty program significantly moderate the reward–performance linkage, which makes balancing target and bystander customer effects a challenging task. For example, explicitly and clearly communicating the rules of a loyalty program helps decrease bystander customer perceptions of unfairness, but at the same time, it reduces the level of target customer gratitude. Alternatively, making rewards highly visible and salient in a program enhances the target customer’s status, but it also reinforces bystander customers’ perceptions of unfairness. Using our detailed findings, we offer guidelines for delivering loyalty programs in ways that can enhance overall program performance.

Fourth, we offer and empirically test a holistic, mediated evaluation model (gratitude, status, unfairness) of loyalty program effectiveness, which accounts for three interrelated aspects that are critical to understanding the net effect of a loyalty program on firm performance. Each reward element in a loyalty program can have simultaneously conflicting (+/-) or supporting (+/+) effects for target/bystander customers, which get enhanced or suppressed depending on the reward delivery process. Thus, the total effect of a loyalty program, with its multiple reward elements, on firm performance is the sum of all reward elements’ positive and negative moderated effects, across the portfolio of target and bystander customers. This loyalty program evaluative framework should help researchers and managers advance their efforts to understand loyalty program effectiveness.

Understanding Loyalty Program Effectiveness

American Airlines introduced the first frequent flyer program in 1981, initiating a surge of programs across industries, including hotels (e.g., Starwood Preferred Guest), financial services (e.g., American Express Centurion), and retailers (e.g., Macy’s Star Rewards) (Brierley 2012; Ferguson and Hlavinka 2009). Loyalty programs encompass various marketing activities, including reward cards, gifts, tiered service levels, dedicated support contacts, and other methods for enhancing customers’ attitudes and behaviors. In line with Henderson, Beck, and Palmatier (2011, p. 58), we define a *loyalty program* as “any institutionalized incentive system that attempts to enhance consumers’ consumption behavior over time.” Despite their proliferation and popularity, the performance of loyalty programs frequently falls short of expectations, leaving managers and researchers to struggle to determine the cause (Kumar and Reinartz 2006). We propose that understanding loyalty program effectiveness demands an expanded evaluative

framework, as we depict in Figure 1 (Figures follow Tables throughout at the end of the document.) for a typical airline program.

Perspectives for understanding loyalty program effectiveness

Customer portfolio perspective. Extant research analyzes loyalty program performance by examining the impact of loyalty programs on customers who receive program rewards (Liu 2007; Verhoef 2003); that is, the target customer is the unit of analysis. However, a broadened perspective should include the firm's entire customer portfolio as the unit of analysis to determine loyalty program performance (point ❶ in Figure 1). In any loyalty program, there are two types of customers: *target customers* (targets) who receive rewards, and *bystander customers* (bystanders) who observe the target customers receiving rewards. The former might express the positive response that the company intended, but the latter might exhibit unintended negative reactions that lower overall program effectiveness. Although the presence and number of bystanders varies in different programs, we argue that their unintended negative effects are a widely underestimated phenomenon. Even if a company considers itself sheltered from bystander effects, because it delivers rewards to targets without involving other customers, we call for caution. Bystander effects occur not only directly, through explicit observation, but also indirectly, through customers' communication and word of mouth (Tax, Chandrashekar, and Christiansen 1993).

Reward element perspective. Typically, loyalty programs encompass multiple rewards (point ❷ in Figure 1). Previous studies investigate loyalty program effects on an aggregate level (Meyer-Waarden 2007) or else compare rewards on an abstract level (i.e., product-related versus non-product-related; Yi and Jeon 2003), without differentiating the specific reward elements within a program. We suggest that these approaches can lead to misleading conclusions too, because specific rewards likely have differential impacts, on both targets and bystanders. For example, some rewards might only affect targets, and others might have similar magnitudes but opposing effects on targets and bystanders. An aggregate program-level analysis cannot distinguish which of the two rewards negatively affects bystanders. A finer-grained analysis of the individual rewards would provide rich insight into each reward's impact on targets and bystanders, as well as its unique contribution to overall program performance.

Reward delivery perspective. It matters not only which rewards are given to target customers, but also how (point ③ in Figure 1). Companies take different approaches to delivering rewards to their target customers (e.g., Ritz-Carlton rewards are not publicized, Marriott sends a reward summary every month). Extant research tends to focus on how reward delivery affects target customer performance, such as when Palmatier et al. (2009) show that customers' gratitude for a reward increases when they perceive more free will and benevolence in the reward provision. Applying a customer portfolio perspective to analyzing loyalty programs reveals that many reward delivery decisions affect both targets and bystanders though. For example, priority treatment might be delivered to target customers in private or in public, with very different effects, in that the positive status lift to targets and the negative status drop suffered by bystanders get magnified in public settings. These varying delivery methods likely have differential effects on target and bystander customer responses. By explicitly including reward delivery into program analyses, we evaluate *what* rewards to adopt, as well as *how* to implement them to maximize program effectiveness.

Loyalty-influencing mechanisms: Customer gratitude, status, and unfairness

Expanding the perspective to include the effects of bystanders, multiple reward elements, and reward delivery on loyalty program performance also requires the conceptual model to include three loyalty-influencing mechanisms (gratitude, status, and unfairness), to capture both positive and negative effects of rewards on target and bystander customers. We note gratitude's generally positive influence on target customers and the strong negative influence of unfairness perceptions on bystander customers. Status instead can have both positive and negative effects, such that targets typically feel elevated status while bystanders experience reduced status. We review extant literature pertaining to these three mechanisms in Table 1 (Tables follow References throughout at the end of the document.).

Customer gratitude. A key construct for understanding the effect of rewards is *customer gratitude* (Emmons and McCullough 2004; Morales 2005), which represents "the emotional appreciation for benefits received, accompanied by a desire to reciprocate" (Palmatier et al. 2009, p. 1). An investment in a relationship can create a strong affective response in terms of feelings of gratefulness, thankfulness, or appreciation for the intentionally rendered benefit (Emmons 2004). Stemming from feelings of gratitude, receivers of a benefit also want to behave

reciprocally (Cialdini 2009; Palmatier et al. 2009). Previous research thus demonstrates the effect of rewards on gratitude (Dawson 1988; Morales 2005). Palmatier et al. (2009) also demonstrate that customer gratitude strongly links relationship investments to performance.

Customer status. Enhancing status is an important customer goal, in the sense that *customer status* refers to the customer's perception of holding an elevated position or rank within a firm's customer hierarchy (Drèze and Nunes 2009; Wagner, Hennig-Thurau, and Rudolph 2009). According to social comparison theory (Festinger 1954), human beings have a natural urge to compare themselves with others, sometimes even without being aware of doing so (Gilbert, Giesler, and Morris 1995). Social comparisons can focus upward, laterally, or downward, allowing people to draw inferences about their own position and rank. The favorability of these assessments strongly affects subjective well-being (Diener 1984; Wood 1996).

Henderson, Beck, and Palmatier (2011) identify status as a primary loyalty-inducing mechanism. Specifically, so-called hierarchical loyalty programs institutionalize status by establishing an explicit, visible hierarchy, consisting of several customer tiers (e.g., bronze, silver, gold). Research demonstrates that the number of hierarchical levels in a loyalty program enhances customers' status perceptions in the elite tier, whereas the increasing size of the elite tier reduces status perceptions (Drèze and Nunes 2009). However, status structures also have downsides; customer demotion, or a loss of elevated status when a customer fails to meet the program requirements, results in decreased loyalty (Wagner, Hennig-Thurau, and Rudolph 2009). Also, the more elite status levels a program has, the more non-elite customers feel inferior, due to their unfavorable upward comparisons (Drèze and Nunes 2009).

Customer unfairness. Finally, unfairness is a sort of "relationship poison" that evokes strong negative customer reactions (Samaha, Palmatier, and Dant 2011, p. 99). We define *customer unfairness* as a customer's view of the degree to which the ratio of their received outcomes relative to their inputs, compared against the corresponding input–outcome ratios of other customers, is unacceptable or inequitable (Henderson, Beck, and Palmatier 2011). This role of unfairness reflects equity theory, which suggests that people should receive benefits or outcomes proportional to the relative efforts or inputs they contribute (Adams 1965; Brown, Cobb, and Lusch 2006). When people perceive their own input–outcome ratio as inequitable, compared with another's, they often feel anger or tension. Typically, people respond to this perceived unfairness by adjusting their own efforts or inputs or punishing the exchange party to restore a

more equitable state (Adams 1965; Utne and Kidd 1980). Loyalty programs likely trigger unfairness perceptions, due to cross-customer comparisons. Previous studies on targeted promotions indicate that negative effects on non-targeted customers arise from concerns about unfairness (Darke and Dahl 2003; Feinberg, Krishna, and Zhang 2002).

Conceptual Model and Hypotheses

Our conceptual model links loyalty program rewards to performance outcomes (customer loyalty and incremental sales) through three loyalty-influencing mechanisms (gratitude, status, and unfairness). *Customer loyalty* reflects a “deeply held commitment to rebuy or repatronize a preferred product or service consistently in the future” (Oliver 1997, p. 392), whereas *incremental sales* capture the customer’s heightened or lowered annual sales in response to the loyalty program. Unlike previous work, our conceptual model includes the effects on target and bystander customers, to draw a more holistic picture of loyalty program effectiveness (Figure 2).

Effect of loyalty programs on target and bystander customers

Loyalty programs can positively affect target customers through two main mechanisms (gratitude and status). Receiving a reward from a company elicits a target customer’s gratitude, because as the customer becomes aware of receiving some benefit from a loyalty reward, such as a small surprising gift, he or she should experience feelings of gratitude. Gratitude represents a typical affective reaction when a person receives some kind of benevolence (Palmatier et al. 2009). To create gratitude, the rendered benevolence must be perceived as intentional and based on the provider’s good intentions (Bonnie and De Waal 2004; Gouldner 1960). Loyalty programs provide benefits to reward customers’ patronage, so in response, the customer feels grateful and reciprocates with more patronage (Dahl, Honea, and Manchanda 2005; Morales 2005).

Status offers another powerful force that firms can use to influence target customers’ behavior (Henderson, Beck, and Palmatier 2011). Imagine a gold status frequent flier is invited by airline personnel to walk over a red carpet for priority boarding, while all other customers must wait in line and watch. Not only does this special reward let the customer board first, but it also gives him or her a sense of superior status relative to the other, “ordinary” customers. The customer is awarded exclusive elite status by the company, accompanied by an affirmative

identity (Tajfel and Turner 1979) and favorable social comparisons (Festinger 1954) that reinforce high perceived status.

H₁: Loyalty program rewards positively affect target customers' (a) gratitude and (b) status.

We propose that the same loyalty programs that positively affect target customers can have a negative effect on bystander customers through two mechanisms (status and unfairness). A bystander who observes another customer receiving a reward that he or she does not get might feel inferior in terms of status. Imagine the bystander, watching the gold status frequent flier bypass the long waiting line. When loyalty programs use status benefits to provide special treatment and recognition to target customers, they also reduce bystander customers' status, making them feel inferior (Drèze and Nunes 2009).

Perceived unfairness also can be a serious threat to customer relationships and performance (Darke and Dahl 2003; Feinberg, Krishna, and Zhang 2002). According to equity theory (Adams 1965), people compare their own input–outcome ratios to those of others (Henderson, Beck, and Palmatier 2011). When they think their ratios are worse, they feel unfairly treated and experience tension or anger. For example, when Alaska Airline's flight attendants hand out free drink coupons to premium customers in coach who were not upgraded, neighboring bystanders may feel unfairly treated. Assuming that all customers paid the same ticket price and contributed the same input, bystanders may deem it unfair that others get free drinks or more outcomes.

H₂: Loyalty program rewards (a) negatively affect bystander customers' status and (b) positively affect bystander customers' unfairness.

Effect of loyalty-influencing mechanisms on performance outcomes

Feelings of gratitude spur an ingrained psychological pressure to behave reciprocally toward the giver of a benefit, thereby increasing that giver's performance (Palmatier et al. 2009). By bestowing a reward on loyalty program customers, the firm intentionally invests in target customers. This benevolent act should enhance their desire to give something back to the firm, resulting in gratitude-based reciprocal behaviors. As previous research suggests, customers act on their desire to behave reciprocally in response to their feelings of gratitude by changing their purchase behavior, in the firm's favor (Dahl, Honea, and Manchanda 2005; Morales 2005). Following this rationale, we expect customer gratitude to enhance customers' loyalty and incremental purchases from that firm.

In addition, “the allure of status is profound” (Henderson, Beck, and Palmatier 2011, p. 259). Dwyer, Schurr, and Oh (1987) cite status and social recognition as important relational longevity forces. People are naturally drawn to status-based systems and seek opportunities to demonstrate their own superior status (Heffetz and Frank 2011). Status rewards are effective in driving positive outcomes (Drèze and Nunes 2011; Lacey, Suh, and Morgan 2007). Customers who receive preferred status within a loyalty program, such as by being assigned to an elevated customer tier in a hierarchical program, want to maintain their superior position, so they increase their patronage to exhibit their higher status and retain their level. These status-based feelings and behaviors lead to increased loyalty and incremental sales (Lacey, Suh, and Morgan 2007).

Alternatively, unfairness can act as relationship poison, seriously jeopardizing both the relationship and performance (Samaha, Palmatier, and Dant 2011). Whereas perceptions of fairness exert a strong positive influence on the quality of a relationship (Kumar, Scheer, and Steenkamp 1995), unfairness, its negative counterpart, can prompt customers to withdraw from a relationship and, in the worst case, try to punish the firm for its unfair behavior (Feinberg, Krishna, and Zhang 2002). Customers experiencing unfair treatment relative to others thus feel motivated to search for alternative firms, in the hope of receiving more acceptable, equitable treatment or as a means of punishing the firm. By reducing their input into the relationship, customers seek to restore the input–outcome ratio balance. Thus, we expect customers that feel unfairly treated to reduce their loyalty and sales to the responsible firm.

H₃: Customer gratitude positively affects customers’ (a) loyalty and (b) incremental sales.

H₄: Customer status positively affects customers’ (a) loyalty and (b) incremental sales.

H₅: Customer unfairness negatively affects customers’ (a) loyalty and (b) incremental sales.

Moderating effect of loyalty program delivery: Rule clarity and reward visibility

Two key program delivery characteristics may moderate the effects of program rewards on target and bystander customers’ gratitude, status, and unfairness: rule clarity and reward visibility. These moderating factors are both managerially relevant (i.e., under managers’ control) and provide contrasting tests of our theoretical linkages, such that they may increase confidence in the nomological validity of our conceptual model. In addition, each factor has differential effects on target and bystander customers, thus demonstrating the importance of a customer portfolio perspective in evaluations of loyalty program effectiveness.

First, we argue that the *rule clarity* for why a customer receives or does not receive a reward diminishes the positive effect of a reward on target customers' gratitude. That is, target customers react less positively and less gratefully to a reward when the rules are clear to them. When customers consciously meet the rules, as openly communicated by the company, they feel entitled to the reward, because they deserve it and have worked for it (Palmatier et al. 2009). In line with attribution theory (Folkes 1988; Weiner 1985), they attribute the reward to themselves rather than interpreting it as a benevolent act by the firm. In contrast, if rules are unclear, customers remain unsure about why they were selected to receive the reward. In this case, the reward comes as a positive surprise, which creates stronger feelings of gratitude.

At the same time, rule clarity should help alleviate bystander customers' unfairness perceptions. By communicating and enforcing a clear set of rules, the loyalty program can increase perceptions of fairness, whereas bystanders observing other customers receiving rewards without an evident reason might perceive the company's action as highly unfair. For them, the allocation of rewards seems random, because they are not aware of the underlying policy. If bystander customers learned, through the firm's communications, that the target customers only received rewards because they worked to accumulate the prerequisite amount of points in the loyalty program, these feelings of unfairness would diminish. Because the target customers worked for the reward, their input–output ratio should appear equivalent to that of a bystander who has neither worked for nor received a reward. Rule clarity thus helps inform bystanders about the firm's underlying “fair” policies (more outcome for more input).

H₆: As rule clarity increases, the effect of loyalty program rewards on (a) target customers' gratitude and (b) bystander customers' unfairness gets suppressed.

Second, we propose that the *reward visibility*, or the salience of a target customer receiving a reward for bystander customers, affects the perception of status for both target and bystander customers. Status conferral can occur in two ways (Henderson, Beck, and Palmatier 2011), that is, either achievement recognized by socially accepted norms or esteem received directly from others (Van Prooijen, Van den Bos, and Wilke 2002). Thus, status can be attained in private and in public, or in some combination (Anderson et al. 2001). Consider a hierarchical loyalty program that stratifies customers into several tiers. A platinum customer might carry a platinum-colored card in his or her wallet (private) but also be invited to walk down a red carpet, in front of all other customers (public). In the first case, the customer senses his or her elevated status, because the loyalty program's rules establish that platinum is the highest tier a customer can

reach. In the second case, the firm makes a publicly visible statement about the customer's importance by conspicuously distinguishing him or her from other customers. The salience of the company's status conferral should enhance the target's status feelings.

From the bystander customer's perspective, publicly observing the "red carpet treatment" of a target customer should aggravate perceptions of inferior status. In parallel with our target customer example, a basic tier customer, with a blue-colored card in his or her wallet, is aware of his or her low status, because the program rules emphasize the tiers above the basic level for "better" customers. Being demoted in public by having to wait in line while the "better" customers pass by likely aggravates these feelings of inferior status (Henderson, Beck, and Palmatier 2011).

A bystander also might perceive the loyalty program as more unfair when explicitly exposed to the rewards granted to target customers. A customer might know that a firm treats its customers differently (e.g., from reading the loyalty program's rules) and that he or she is not treated preferentially. Such a general consciousness of different treatments could evoke feelings of unfairness, but when the customer learns about his or her discrimination by being explicitly and visibly neglected in favor of a premium customer, these unfairness perceptions get strongly substantiated. The visibility of the reward delivery thus enhances both positive and negative mechanisms linking rewards to performance, by making the underlying processes more salient to target and bystander customers (Barone and Roy 2010; Feinberg, Krishna, and Zhang 2002).

H₇: As reward visibility increases, the effect of loyalty program rewards on (a) target customers' status, (b) bystander customers' status, and (c) bystander customers' unfairness increases.

Methodology

To test our conceptual model, we conducted three complementary studies (two lab experiments and a field study). As study contexts, we chose airlines and hotels. Both market sectors rank among the top five U.S. loyalty program industries, accounting for 63% of total loyalty program memberships in the United States (Ferguson and Hlavinka 2009). The loyalty programs examined in our studies parallel actual programs in these industries.

Consistent with our framework for analyzing loyalty program performance, our studies integrate all three perspectives. The two experimental studies account for both the *customer portfolio* (by manipulating targets and bystanders) and *reward delivery* (by manipulating rule

clarity and reward visibility). Our field study also considers the *customer portfolio* as our fundamental unit of analysis while adding multiple *reward elements* to the model (e.g., priority boarding, free services), which allows each customer to be a target for some rewards and a bystander for others (typical scenario).

Experimental studies (Studies 1 and 2)

Research design and participants. To investigate the effect of loyalty programs on performance outcomes for both target and bystander customers and the moderating impacts of rule clarity and reward visibility, we conducted two experimental studies, using parallel approaches. In each study, we employed a 2×2 between-subjects factorial design with a control group. Thus, we had four loyalty program treatment groups and one control group without any loyalty program. Within the treatment groups, we manipulated customer type (target versus bystander) and one program delivery characteristic. Specifically, in Study 1, we manipulated the loyalty program's rule clarity (low versus high), then in Study 2, we manipulated its reward visibility (low versus high). To isolate the effects of loyalty programs on targets and bystanders, the control group featured no loyalty program (see Wagner, Hennig-Thurau, and Rudolph 2009); it served as the reference group, allowing us to disentangle a program's positive effect on target customers versus the control group from the negative effect on bystander customers versus the control group, which would not be possible if we simply compared target and bystander customers (because the positive and negative effects would be aggregated).

For the data collection, we used Amazon's Mechanical Turk (MTurk). Compensation for respondents completing the questionnaire was \$.40. MTurk has become a common source of participants and provides access to data whose quality and representativeness is equivalent to that of data generated through traditional sampling approaches (Berinsky, Huber, and Lenz 2012; Paolacci, Chandler, and Ipeirotis 2010). In Study 1, 234 participants took part in the experiment. Their mean age was 30.2 years, 43.0% were women, and 54.9% had attained a college degree. Overall, 232 participants took part in Study 2. Participants had an average age of 30.5 years, 42.7% were women, and 50.5% had completed their college education. In both studies, respondents were randomly assigned to one of the five groups.

Procedure. Each participant received a short scenario and a questionnaire. The scenario described the participant's past relationship with the fictitious airline SkyStar (Study 1) or the

fictitious hotel chain BestResidence (Study 2). Next, participants in Study 1 were told to imagine that they were on another flight with SkyStar and that, after takeoff, the flight attendant distributed drinks and headphones to customers. In the loyalty program treatment groups, participants were told that the flight attendant handed out free drinks and headphones to selected customers who were members of the airline's loyalty program. To manipulate the customer type, participants belonged to either the group of customers that received the reward (target customers) or not (bystander customers). The rule clarity was manipulated by giving participants a reason for (not) being selected to receive the free drinks and headphones. In the low clarity groups, participants were not provided with any reason; in the high clarity groups, participants read that they were (not) selected because their past flight history does (not) meet the reward guidelines published on the company's website. In the control group, the airline did not operate a loyalty program, so no one received any reward, but both bystanders and the control group could buy drinks or headphones for an additional charge. The control group remained unaware of any differential customer treatment, whereas the bystander customer group realized that other customers received some reward. We detail these scenarios in Appendix 1.

Study 2 participants were told to envision staying overnight at a BestResidence hotel and entering the lobby to check in to their room. The treatment groups read of two check-in counters in the lobby, a normal customer check-in counter, where customers must wait in line, and a premium customer check-in counter, where customers walk over a red carpet and check in without any wait. We manipulated the customer type by informing participants that they were entitled to use the premium customer check-in counter (target customers) or the check-in counter for normal customers (bystander customers). We manipulated the reward visibility by varying the salience of the preferential treatment. In the low visibility groups, target customers were informed that the lobby was empty when they were checking in, so no other customers were waiting at the normal customer check-in counter. Bystander customers read that as they were waiting in line, no premium customers checked in. For the high visibility groups, the scenario for target customers indicated that waiting customers watched them check in, and the scenario for bystander customers revealed that they observed several premium customers checking in. For the control group, multiple, similar check-in counters existed, but without any loyalty program.

Manipulation and realism checks. The results of the manipulation check supported the effectiveness of our treatments. To test our customer type manipulation, we asked the

participants in all groups to indicate whether they were treated preferentially, relative to other customers (Study 1: $M_{\text{target}} = 5.69$, $SD = 1.14$; $M_{\text{bystander, control}} = 2.71$, $SD = 1.40$; $t = 17.42$, $p < .01$; Study 2: $M_{\text{target}} = 5.55$, $SD = 1.56$; $M_{\text{bystander, control}} = 3.28$, $SD = 1.45$; $t = 10.91$, $p < .01$), and whether other customers were treated preferentially relative to themselves (Study 1: $M_{\text{bystander}} = 5.29$, $SD = 1.69$; $M_{\text{target, control}} = 3.23$, $SD = 1.51$; $t = 9.51$, $p < .01$; Study 2: $M_{\text{bystander}} = 5.25$, $SD = 1.45$; $M_{\text{target, control}} = 2.80$, $SD = 1.40$; $t = 12.51$, $p < .01$). As a measure of the success of our manipulation of rule clarity in Study 1, participants reported whether the rules for why SkyStar distributed rewards just to certain customers were clear to them ($M_{\text{low clarity}} = 2.59$, $SD = 1.78$; $M_{\text{high clarity}} = 5.14$, $SD = 1.68$; $t = 9.32$, $p < .01$). In the test of the program's reward visibility manipulation in Study 2, respondents rated whether the preferential treatment at the premium customer check-in counter was visible to others (i.e., target) or to them (i.e., bystander) ($M_{\text{low visibility}} = 5.45$, $SD = 1.79$; $M_{\text{high visibility}} = 6.45$, $SD = 1.08$; $t = 4.20$, $p < .01$). The results of the realism check for both studies also indicated that respondents could envision themselves in the situations (Study 1: $M = 5.60$, $SD = 1.27$; Study 2: $M = 5.60$; $SD = 1.43$).

Measures. We used established multi-item scales to measure customer gratitude, status, unfairness, and loyalty. All items used seven-point Likert-type scales, ranging from 1 = "strongly disagree" to 7 = "strongly agree." We measured incremental sales by asking respondents to indicate their expected percentage change in spending with the focal firm over the next year. To account for any additional effects and ensure that we could specify the effects of our proposed mechanisms, separate from alternative explanations, we included several control variables in the model: each respondent's personal experience with loyalty programs and with airlines/hotels, as well as customer value, because many loyalty rewards offer some monetary benefit or time savings, in addition to the psychological benefits and costs we investigate (Liu 2007). The construct measures, scale sources, and item loadings are in Appendix 2.

We conducted a confirmatory factor analysis (CFA) on the combined sample from Studies 1 and 2 to evaluate the psychometric properties of our multi-item constructs. The fit indices were acceptable ($\chi^2_{(91)} = 255.11$, $p < .01$; comparative fit index [CFI] = .98; incremental fit index [IFI] = .98; root mean square error of approximation [RMSEA] = .06). The scales showed convergent validity, according to the factor loadings ($\geq .71$), Cronbach's alphas ($\geq .89$), and average variance extracted ($\geq .73$). In support of discriminant validity, each construct's square root of the average variance extracted exceeded all construct correlations, as we note in Table 2.

Analysis and results. We assessed the overall conceptual model using partial least squares (PLS) and thus could analyze the overall nomological framework by simultaneously examining the complex, mediated relationships between target and bystander participation in loyalty programs and performance outcomes. To disentangle the effects of loyalty programs on target and bystander customers, we compared these two customer groups against our control group. We used dummy coding to dichotomize the three independent variable categories and defined the no loyalty program control group as our reference category (Henseler and Fassott 2010). Path coefficients represented the effect of receiving the reward (target customers) or observing the target customer receive the reward (bystander customers), compared with customers in a firm with no loyalty program. Therefore, we isolated the target's increased and bystander's decreased reactions to participating or observing participation in a loyalty program.

The path coefficients in Table 3 show that the path between target customers and gratitude was positive and significant in Study 1 ($\beta = .55, p < .01$) and Study 2 ($\beta = .20, p < .01$), in support of H_{1a}. Being a target customer had a positive impact on status in Study 1 ($\beta = .61, p < .01$) and Study 2 ($\beta = .36, p < .01$), in support of H_{1b}. In line with H_{2a}, the path between bystander and status was negative and significant in both studies (Study 1: $\beta = -.21, p < .01$; Study 2: $\beta = -.34, p < .01$). The results from Study 1 ($\beta = .61, p < .01$) and Study 2 ($\beta = .42, p < .01$) instead indicated a positive impact of being a bystander customer on unfairness, in support of H_{2b}. As we hypothesized in H_{3a} and H_{3b}, gratitude exerted a positive influence on both loyalty (Study 1: $\beta = .20, p < .01$; Study 2: $\beta = .16, p = .03$) and incremental sales (Study 1: $\beta = .13, p = .06$; Study 2: $\beta = .23, p < .01$), though the latter effect was only marginally significant in Study 1. Also in Study 1, status positively affected loyalty ($\beta = .20, p < .01$) and incremental sales ($\beta = .25, p < .01$), which supported H_{4a} and H_{4b}. For Study 2, we cannot confirm H_{4a} though, because the path coefficient between status and loyalty was not significant ($\beta = -.01, p = .45$). Consistent with H_{4b}, status positively affected incremental sales ($\beta = .15, p = .04$). Finally, in both studies, unfairness harmed loyalty (Study 1: $\beta = -.33, p < .01$; Study 2: $\beta = -.42, p < .01$) and incremental sales (Study 1: $\beta = -.26, p < .01$; Study 2: $\beta = -.16, p < .01$), respectively, providing support for both H_{5a} and H_{5b} across both studies. Of the control variables, in Study 1, the path between value and loyalty was significant. In Study 2, we also found significant effects of the respondent's experience with loyalty programs on gratitude and unfairness and of value on loyalty.

To determine if the effects of being a target or bystander on performance outcomes were fully mediated by our proposed mechanisms, we estimated rival models for both Study 1 and 2, in which we included direct paths from target and bystander customers to performance outcomes. Only one of the eight direct paths was significant. Specifically, in Study 2, the effect of being a target customer on loyalty was only partially mediated; the direct path between the constructs was significant ($\beta = .10, p = .04$). All other effects were fully mediated.

We also conducted a series of analyses of variance (ANOVAs) to investigate the moderating effect of loyalty program delivery characteristics. In Study 1, we assessed the moderating role of the program's rule clarity on the link between target customers' participation and gratitude and between bystander customers' observation of program rewards and unfairness. In support of H_{6a}, gratitude among target customers was significantly lower in the high compared with the low clarity condition ($M_{\text{target, high clarity}} = 5.20, SD = 1.25; M_{\text{target, low clarity}} = 5.78, SD = 1.02; F = 5.28, p = .01$). In line with H_{6b}, bystander customer unfairness was significantly lower in the high clarity condition compared with the low clarity condition ($M_{\text{bystander, high clarity}} = 4.09, SD = 1.80; M_{\text{bystander, low clarity}} = 4.73, SD = 1.49; F = 3.02, p = .04$).

With Study 2, we examined the moderating effects of the program's reward visibility. As we proposed in H_{7a}, target customers' status in the high visibility condition was significantly higher than in the low visibility condition ($M_{\text{target, high visibility}} = 5.59, SD = 1.09; M_{\text{target, low visibility}} = 4.90, SD = 1.52; F = 5.08, p = .01$). For bystander customers, status was lower in the high visibility than the low visibility condition ($M_{\text{bystander, high visibility}} = 2.58, SD = 1.27; M_{\text{bystander, low visibility}} = 3.00, SD = 1.39; F = 1.96, p = .08$), though the effect was only marginally significant, in marginal support of H_{7b}. Consistent with H_{7c}, bystander customers' unfairness were significantly higher in the high visibility condition ($M_{\text{bystander, high visibility}} = 3.92, SD = 1.77; M_{\text{bystander, low visibility}} = 2.73, SD = 1.63; F = 9.75, p < .01$).

Discussion and customer portfolio analysis. The results of our experimental studies reveal two important insights about loyalty program performance. First, the intended positive effect on target customers gets undermined by simultaneous, unintended negative effects on bystander customers, mediated by gratitude, status, and unfairness. Second, the program's rule clarity decreases both positive target and negative bystander customer effects; the program's reward visibility simultaneously increases positive target and negative bystander customer effects. These opposing effects generate a dilemma for program designers, who must answer two managerially

relevant questions, (1) *How can a manager know if a loyalty program's gain among target customers outweighs losses due to bystanders?* and (2) *How can a manager know the net effect of changing a delivery characteristic if it has opposing effects on targets and bystanders?*

To gain insight into these questions and demonstrate the customer portfolio and reward delivery perspectives, we conducted a *customer portfolio analysis* in which we evaluated loyalty program performance for different ratios of bystander-to-target customers. With an analytical model, we predicted loyalty program performance (incremental annual profit \$) for a generic portfolio of target and bystander customers (Appendix 3). Using this model and the results from the airline loyalty program (Study 1), we could determine the profit-related impact of the loyalty reward, as a function of the number of bystanders per target customer, at different levels of rule clarity, as we illustrate in Figure 3.

A review of Figure 3 reveals several key insights. First, the negative bystander response to this loyalty program significantly degrades its effectiveness. For each additional bystander that observes the target customer receiving a loyalty reward, the program's annual profit contribution drops by about \$2.60, until the program's net effect becomes negative when 13 or more bystanders observe a target customer receiving the reward (solid line). At this point, the intended incremental gain from the target customer is completely offset by the unintended incremental losses brought about by bystander customers. Second, our analysis provides insights into the complex moderated–mediated effects of loyalty program design characteristics. In this example, firms should have very clear loyalty program rules, because greater clarity shifts the bystander breakeven point from 13 to 19 (dotted line), thereby improving loyalty program performance. Although clear rules suppress the program's positive impact on targets' gratitude (negative effect), they more than make up for it by suppressing the program's effect on bystanders' unfairness perceptions (positive effect). Lowering the rule clarity instead shifts the breakeven point from 13 to 9 (dashed line) and harms loyalty program performance. The results and guidance from this analysis depend on the specific program and related assumptions, and thus should not be generalized to other programs, but a customer portfolio approach can be valid in many loyalty program contexts, to account for the effects of bystanders and reward delivery.

Field study (Study 3)

Study 3 integrates the third, *reward element perspective* into our conceptual model. The constructs and measures remain the same, but rather than testing the moderating effect of specific delivery characteristics, we include multiple reward elements (e.g., priority check-in, lounge access), such that each customer can be a target for some rewards and a bystander for other rewards (a more realistic scenario). This refinement is critical, because an aggregate analysis of programs with multiple reward elements can lead to misleading conclusions about the unique effects of specific rewards on targets and bystanders. In addition, replicating our model in a field setting increases confidence in the validity and generalizability of our framework.

Research design and participants. To analyze the effect of the loyalty program on target and bystander customers in the field, we conducted a survey of actual airline customers. Customers reported their experiences with an airline they used on a recent flight; to minimize recall bias, we required the respondents to have flown within the previous two weeks to qualify for the study. We recruited subjects through MTurk by offering \$.50 compensation. In total, 265 participants completed the survey. Their mean age was 30.9 years, 40.5% of participants were women, and 60.8% had a college degree. On average, respondents' flight occurred 7.8 days before data collection. The top airlines flown were Delta (21.9%) and American Airlines (20.8%).

Procedure. We first asked respondents to provide some data about their recent flight. Next, a list of airline loyalty rewards appeared, including priority check-in, free checked bag, lounge access, priority boarding, and free services (e.g., beverages, food). These rewards were identified from a review of existing airline loyalty programs. For each reward, respondents indicated if (1) they received this benefit themselves (i.e., target customer) or (2) they saw other customers receive this benefit while they did not receive it (i.e., bystander customer). Selecting neither choice meant that a specific reward element was not received or observed by the respondent.

Measures. With this study, we allow a customer to be a target for one or several reward elements in a loyalty program and a bystander for one or several other reward elements in the same program. Following the guidelines for index construction (Diamantopoulos and Winklhofer 2001; Jarvis, Mackenzie, and Podsakoff 2003), we operationalized loyalty program targets and bystanders as formative constructs. For each of the five reward benefits measured, respondents indicated whether they received that benefit (coded as 1) or not (coded as 0). These five dimensions jointly added to form the target customer measure. In addition, participants stated for

each reward benefit whether, instead of themselves receiving the benefit, they saw other customers receive it (coded as 1) or not (coded as 0). Again, these five dimensions additively formed the bystander construct. All other measures were identical to Studies 1 and 2, except that we also measured customer share of wallet at the focal airline, added as a control variable to account for ceiling effects (see Appendix 2).

We assessed the psychometric properties of all reflective multi-item constructs in Study 3 by conducting a CFA. The indices indicated acceptable fit ($\chi^2_{(91)} = 199.78, p < .01$; CFI = .98; IFI = .98; RMSEA = .07). The factor loadings ($\geq .65$), Cronbach's alphas ($\geq .87$), and average variance extracted ($\geq .73$) indicated convergent validity. In support of discriminant validity, the square root of the average variance extracted for each construct was greater than all construct correlations. We provide the descriptive statistics and correlations in Table 2.

Analysis and results. We used PLS to estimate our model and report the results in Table 3. Similar to our previous studies, our coding approach allowed the path coefficients to be interpreted as the effect of receiving the reward (targets) or observing target customers receive the reward (bystanders), compared with customers who neither received nor observed a reward being received (i.e., no loyalty program effects). With this approach, we isolated the target lift and bystander drop due to participation in or observation of loyalty rewards.

In support of H_{1a}, we found a positive, significant relationship between target and gratitude ($\beta = .36, p < .01$). Status was positively affected by being a target customer ($\beta = .46, p < .01$), in support of H_{1b}. As suggested by H_{2a}, a negative and significant path emerged between bystander and status ($\beta = -.10, p = .03$). Being a bystander also exerted a positive influence on unfairness ($\beta = .14, p = .02$), in support of H_{2b}. Gratitude had a positive impact on both loyalty and incremental sales ($\beta = .34, p < .01$; $\beta = .23, p < .01$), offering support for H_{3a} and H_{3b}. In marginal support of H_{4a}, the path between status and loyalty was marginally significant ($\beta = .07, p = .05$). Consistent with H_{4b}, status positively affected incremental sales ($\beta = .11, p = .03$). We also noted support for H_{5a} and H_{5b}, because unfairness negatively affected loyalty ($\beta = -.19, p < .01$) and incremental sales ($\beta = -.16, p = .02$). For the control variables, we uncovered significant positive links between the customer's experience with airlines and unfairness, between value and loyalty, and between customer share of wallet and loyalty. Adding direct paths from loyalty program targets and bystanders to both loyalty and incremental sales in a rival model, we found that the effect of

targets on incremental sales was only partially mediated; there was a significant direct path between the two constructs ($\beta = .14, p = .03$). All other effects were fully mediated.

Discussion and reward element analysis. Study 3 reveals multiple insights about loyalty program performance. First, the consistent results from this field study, linking target and bystander participation to performance outcomes through gratitude, status, and unfairness, increase confidence in our conceptual framework. Second, Study 3 shows that the framework holds even when customers receive and watch others receive multiple reward elements contemporaneously, which suggests that overall program effectiveness is the sum of the effects of multiple reward elements in a loyalty program, operating through parallel mechanisms (target gratitude, target and bystander status, bystander unfairness). For example, in a typical airline program with five reward elements, overall program performance equals the sum of 20 individual effects, which cannot be evaluated or managed at the program or target customer levels of analysis. Assuming managers want to evaluate a program at the reward level, to avoid aggregation bias, *how can they isolate the effects of each reward element on incremental sales?*

To gain insights into this question and the reward element perspective, we conducted a *reward element analysis* to isolate the total effect of each reward on incremental sales while also identifying the contributions of target and bystander customers and the three loyalty-influencing mechanisms. Specifically, to reveal a reward's total effect on sales performance for each loyalty-influencing mechanism, we multiplied the reward's formative indicator weight by the respective structural path coefficients for customer gratitude, status, or unfairness, as well as by the structural path coefficients for that mediator's impact on incremental sales. Thus, the resulting total effect of receiving (target) or watching others receive (bystander) a reward on incremental sales represented the sum of the effects through the three mechanisms. To combine target and bystander effects into a net total effect, linking a reward to incremental sales for the overall customer portfolio, we need the average number of bystanders and targets for that reward, as well as base sales levels for both types of customers. The reward element analysis of the five rewards in Study 3 produced the graph we depict in Figure 4.

Comparing the total effects of multiple airline loyalty program rewards on target and bystander customers' incremental sales, through gratitude, status, and unfairness, we found an interesting pattern of results that managers could use to design or improve their loyalty programs. For example, consider the two stacked bars for the "priority boarding" reward. It

slightly enhanced a target customer's incremental sales by fostering gratitude (light gray bar) and status (dark gray bar) (.75% + .46% = 1.21%). But observing this priority boarding by targets upset bystander customers by lowering their status (dark gray bar) and raising unfairness (crosshatched bar), reducing incremental sales (-2.61% + -5.47% = -8.08%). Thus, assuming a 1:1 ratio of bystanders to targets and similar sales levels for both customer types, this reward element's net effect would be to reduce next year's sales by nearly 7% (1.21% - 8.08% = -6.87%). Managers thus should investigate ways to suppress the negative effect on bystanders, especially that due to unfairness (e.g., increase rule clarity, "100,000 milers board now"). Alternatively, the "free services" reward element strongly enhances target customers' gratitude and status and thereby increases incremental sales (7.54% + 4.65% = 12.19%; controlling for value), with only a relatively small effect on bystander customers' incremental sales through status and unfairness (-.76% + -1.59% = -2.35%). Managers should make this program more salient to target customers and add additional reward elements with similar characteristics.

The overall results, across the five reward elements, suggest that providing visible rewards to target customers at the expense of bystanders (making them wait while others get services) is an especially dangerous strategy. The strong negative effects generated among bystanders overwhelm the relatively smaller positive effects from targets, resulting in an overall negative net effect for this widely used reward element (e.g., priority check-in, priority boarding) on portfolio sales. It is not visibility driving these effects since "free services" is also visible and is an effective program, but rather doing so at the *expense of other customers*. The large variations in Figure 4 thus provide managers with actionable insights regarding the most effective reward elements and the underlying composition of the net effects. Across the three mechanisms, our results suggest that for targets, gratitude accounts for 62% of the incremental sales effects, while status makes up 38%. For bystanders, status makes up 32% and unfairness accounts for 68% of the incremental sales effect. Gratitude and unfairness thus represent the key psychological pillars of loyalty program effectiveness; the relative nature of status may undermine its effectiveness.

Conclusion and Implications

Loyalty programs represent nearly ubiquitous marketing instruments, despite their poor, and poorly understood, performance in many cases. We have sought to enhance understanding of loyalty program effectiveness by developing and testing a new conceptual framework that

expands to include three perspectives: customer portfolio, reward elements, and reward delivery. We review our results by discussing these new perspectives, offering implications for theory and practice, and outlining some future research directions.

Perspectives for understanding loyalty program effectiveness

This study provides evidence that extant approaches for evaluating loyalty programs may provide misleading guidance when they ignore the effects on bystander customers, aggregate multiple reward elements, and fail to account for the impact of reward delivery characteristics on program effectiveness. The perspectives proposed in our framework attempt to address these gaps in extant approaches. First, we use a *customer portfolio perspective* to incorporate loyalty program effects on both target and bystander customers. The results from three studies show that though loyalty program performance can be enhanced by fostering gratitude and increasing status among target customers, it is simultaneously suppressed by decreasing status and spurring perceptions of unfairness among bystander customers. These opposing effects may help explain the failure of some loyalty programs to achieve financial objectives.

Second, we use a *reward element perspective* to prevent poor decisions due to an aggregation bias when managers evaluate loyalty programs at higher levels of analysis (e.g., program-level). Study 3 shows that each reward creates a complex pattern of effects across both targets and bystanders and the loyalty-influencing mechanisms, and these patterns emerge only through a reward-level analysis. Insights into these patterns of effects allow managers to make effective reward design decisions, such as eliminating poorly performing rewards (e.g., due to small positive target or large negative bystander effects), changing the delivery of an existing reward (e.g., to suppress a negative bystander effect), or adding a reward to leverage an unexploited loyalty mechanism (e.g., adding a surprise gift to generate missing gratitude-based reciprocity).

Third, a *reward delivery perspective* can help managers leverage reward benefits while minimizing unintended consequences. Insights from Studies 1 and 2 show that understanding optimal delivery is difficult, because delivery characteristics often have opposing effects. For example, rule clarity simultaneously diminishes positive target and negative bystander customer effects, and reward visibility enhances positive target and negative bystander customer effects at the same time. These design characteristics demand careful trade-off decisions.

These three loyalty program perspectives do not operate independently but rather are highly interrelated (as illustrated in Figure 1). For example, target and bystander customers (point ❶) can be simultaneously and differentially affected by each specific reward element (point ❷) in a loyalty program, and each linkage can be enhanced or suppressed, based on the delivery of each reward (point ❸). Thus, the total effect of a loyalty program, with multiple reward elements, on firm performance is the sum of all the reward elements' positive and negative moderated effects across the entire portfolio of target and bystander customers.

Implications for theory and practice

This study reveals several theoretical implications. We obtained strong support, across three studies, that a loyalty program's effect on performance is mediated by gratitude, status, and unfairness simultaneously. Thus, loyalty research that focuses on a single theoretical mechanism may be misspecifying the reward–performance linkage (Henderson, Beck, and Palmatier 2011). This problem even gets aggravated, in that the effect of a loyalty reward on each loyalty-influencing mechanism is moderated differentially by delivery factors, which cannot be isolated in research that focuses on a single theoretical mechanism. Moreover, the large negative effects of rewards on bystanders in some situations suggest the need for more theoretical and empirical work focused on understanding the “dark side” of loyalty programs. For example, nearly all customers began their relationships with the firm as bystanders, but if a firm treats them unfairly or delegates them to low status levels, they may find it hard to develop a strong relationship later. More effort is needed to understand how this model can be adapted to include dynamic or lifecycle effects. Homburg, Droll, and Totzek (2008) find no negative effects of customer prioritization on relationships with bottom-tier customers, which contrasts with our findings, suggesting the need for more research especially in business-to-business contexts.

Managers can use our overall evaluative framework and the approaches outlined in the customer portfolio and reward element analyses. For example, firms need to account for bystander effects rather than just evaluating the benefits to targeted customers, as is typical (Barone and Roy 2010). Insights from the total effects analysis further suggest that companies should conduct audits of the individual reward elements that constitute their loyalty programs to isolate the benefits and costs of each element. Overall, loyalty program management would benefit from more thorough knowledge of the efficacy of each program component and how

delivery factors affect them. Many program characteristics have complex effects; communicating the program rules reduces the effects on targets' gratitude and bystanders' unfairness but also reduces management's flexibility in changing the program over time. Changing the rules thus could raise perceptions of unfairness among both targets and bystanders.

Limitations and further research

We found support for our overall conceptual model across two research formats (i.e., experimental and field studies) and industry contexts. Further research should determine if these results differ in other important loyalty program industries (e.g., financial services, grocery). Investigating the model in different cultures also might yield interesting insights, because perceptions of gratitude, status, and unfairness tend to vary with cultural norms.

Other design characteristics of loyalty program reward delivery deserve attention too. Whereas we demonstrate how the rule clarity and reward visibility influence loyalty program effects on targets and bystanders, other moderating factors are conceivable. For example, customer characteristics, such as the customer's relationship strength, lifecycle stage, or perceived importance to the firm, might emphasize or diminish target and bystander effects and thereby facilitate managers' targeting decisions when designing loyalty programs. Many loyalty programs collect key customer information (Kumar and Reinartz 2006); research should integrate the financial benefits of this information into the analysis to support more balanced decision making.

Appendix 1

Scenario Descriptions

1. Study 1: Airlines

Target Customer/Low Rule Clarity

You are a customer of the international airline SkyStar. You have regularly patronized SkyStar in the past and have always been satisfied. Today, you are on another flight with SkyStar. Check-in is smooth and soon after you settle into your seat the plane takes off on time. You are travelling in coach.

After takeoff, the flight attendant hands out free drink coupons along with free headphones to some customers in coach. You receive the free drink and the free headphones. You are unsure of why you were selected. As usual, other customers are able to purchase drinks and headphones at additional charges.

The plane lands on time at your destination. You get your bag and walk out to the taxi stand.

Target Customer/High Rule Clarity

You are a customer of the international airline SkyStar. You have regularly patronized SkyStar in the past and have always been satisfied. Today, you are on another flight with SkyStar. Check-in is smooth and soon after you settle into your seat the plane takes off on time. You are travelling in coach.

After takeoff, the flight attendant hands out free drink coupons along with free headphones to some customers in coach. You receive the free drink and the free headphones. You were selected because your past flight history meets SkyStar's reward guidelines, which are published on the company's website. As usual, other customers are able to purchase drinks and headphones at additional charges.

The plane lands on time at your destination. You get your bag and walk out to the taxi stand.

Bystander Customer/Low Rule Clarity

You are a customer of the international airline SkyStar. You have regularly patronized SkyStar in the past and have always been satisfied. Today, you are on another flight with SkyStar. Check-in is smooth and soon after you settle into your seat the plane takes off on time. You are travelling in coach.

After takeoff, the flight attendant hands out free drink coupons along with free headphones to some customers in coach. You do not receive the free drink and the free headphones. You are unsure of why you were not selected. As usual, you are able to purchase drinks and headphones at additional charges.

The plane lands on time at your destination. You get your bag and walk out to the taxi stand.

Bystander Customer/High Rule Clarity

You are a customer of the international airline SkyStar. You have regularly patronized SkyStar in the past and have always been satisfied. Today, you are on another flight with SkyStar. Check-in is smooth and soon after you settle into your seat the plane takes off on time. You are travelling in coach.

After takeoff, the flight attendant hands out free drink coupons along with free headphones to some customers in coach. You do not receive the free drink and the free headphones. You were not selected because your past flight history does not meet SkyStar's reward guidelines, which are published on the company's website. As usual, you are able to purchase drinks and headphones at additional charges.

The plane lands on time at your destination. You get your bag and walk out to the taxi stand.

No Loyalty Program (Control Group)

You are a customer of the international airline SkyStar. You have regularly patronized SkyStar in the past and have always been satisfied. Today, you are on another flight with SkyStar. Check-in is smooth and soon after you settle into your seat the plane takes off on time. You are travelling in coach.

After takeoff, the flight attendant comes around with drinks and headphones. As usual, you are able to purchase drinks and headphones at additional charges.

The plane lands on time at your destination. You get your bag and walk out to the taxi stand.

2. Study 2: Hotels

Target Customer/Low Reward Visibility

You are a customer of the international hotel chain BestResidence. You have regularly patronized BestResidence in the past and have always been satisfied. Today, you arrive at a BestResidence hotel for another overnight stay.

When you enter the lobby, there are two check-in counters: a normal customer check-in counter where customers need to wait in line and a premium customer check-in counter where customers walk over a red carpet and check in without any waiting time. You check in at the premium customer check-in counter. While you walk over the red carpet and check in quickly, the lobby is empty; no customers are waiting at the normal customer check-in counter.

You receive your key from the friendly receptionist and go to your room, which meets your expectations.

Target Customer/High Reward Visibility

You are a customer of the international hotel chain BestResidence. You have regularly patronized BestResidence in the past and have always been satisfied. Today, you arrive at a BestResidence hotel for another overnight stay.

When you enter the lobby, there are two check-in counters: a normal customer check-in counter where customers need to wait in line and a premium customer check-in counter where customers walk over a red carpet and check in without any waiting time. You check in at the premium customer check-in counter. While you walk over the red carpet and check in quickly, the lobby is crowded; a lot of customers are waiting at the normal customer check-in counter, watching as you check in.

You receive your key from the friendly receptionist and go to your room, which meets your expectations.

Bystander Customer/Low Reward Visibility

You are a customer of the international hotel chain BestResidence. You have regularly patronized BestResidence in the past and have always been satisfied. Today, you arrive at a BestResidence hotel for another overnight stay.

When you enter the lobby, there are two check-in counters: a normal customer check-in counter where customers need to wait in line and a premium customer check-in counter where customers walk over a red carpet and check in without any waiting time. You check in at the normal customer check-in counter. As usual, you wait in line. While you wait, you do not see a premium customer walk over the red carpet and check in quickly.

You receive your key from the friendly receptionist and go to your room, which meets your expectations.

Bystander Customer/High Reward Visibility

You are a customer of the international hotel chain BestResidence. You have regularly patronized BestResidence in the past and have always been satisfied. Today, you arrive at a BestResidence hotel for another overnight stay.

When you enter the lobby, there are two check-in counters: a normal customer check-in counter where customers need to wait in line and a premium customer check-in counter where customers walk over a red carpet and check in without any waiting time. You check in at the normal customer check-in counter. As usual, you wait in line. While you wait, you see several premium customers walk over the red carpet and check in quickly.

You receive your key from the friendly receptionist and go to your room, which meets your expectations.

No Loyalty Program (Control Group)

You are a customer of the international hotel chain BestResidence. You have regularly patronized BestResidence in the past and have always been satisfied. Today, you arrive at a BestResidence hotel for another overnight stay.

When you enter the lobby, there are several check-in counters. You go over to one of the check-in counters. As usual, you wait in line.

You receive your key from the friendly receptionist and go to your room, which meets your expectations.

Appendix 2

Construct Measures and Item Loadings

Construct (Scale Source): Items	Item Loading
Customer gratitude (adapted from Palmatier et al. 2009):	
I feel grateful to [Company].	.96/.97
I feel thankful to [Company].	.96/.96
I feel appreciative to [Company].	.94/.95
Customer status (adapted from Drèze and Nunes 2009):	
[Company] makes me feel privileged.	.96/.95
[Company] gives me a feeling of high status.	.95/.94
Relative to the other customers, I experience better treatment at [Company].	.80/.65
Customer unfairness (adapted from Samaha, Palmatier, and Dant 2011):	
The way [Company] treats me is unfair.	.95/.96
The way [Company] treats me is unjustified.	.91/.94
Given my behavior as a customer, [Company] treats me unfairly.	.89/.90
Given what [Company] earns from their sales to me, it treats me unfairly.	.81/.82
Customer loyalty (adapted from Wagner, Hennig-Thurau, and Rudolph 2009):	
I will continue buying at [Company].	.90/.96
The next time I need to book a flight/a hotel, I will buy at [Company].	.94/.90
In the future, I will purchase at [Company].	.90/.92
Incremental sales:	
Based on the described situation, please estimate your % change (increase or decrease) in spending at [Company] within the next year. (percentage)	N.A.
I will increase my spending at [Company] by ___% within the next year. OR	
I will decrease my spending at [Company] by ___% within the next year. OR	
I will not change my spending at [Company] within the next year.	
Experience loyalty programs:	
How many reward program memberships (e.g., airlines, hotels, grocery stores) do you have? (absolute number)	N.A.
Experience airlines/hotels:	
On average, how many flights do you do (for private and business purposes) per year? (absolute number)	N.A.
Customer value (adapted from Sirdeshmukh, Singh, and Sabol 2002):	
[Company] helps me save money.	.71/.85
[Company] is a “good deal” for me.	.92/.93
[Company] provides me value.	.92/.94
Customer share of wallet:	
Considering your total spending (in US\$) at airlines per year, what portion of this amount do you spend at [Company]? (percentage)	N.A.

Notes: N.A. = not applicable. All items were measured on a seven-point Likert-type scale ranging from 1 = “strongly disagree” to 7 = “strongly agree,” unless otherwise noted. Item loadings are reported as combined Study 1 and 2/Study 3.

Appendix 3

Loyalty Program: Customer Portfolio Analysis Derivation

To derive our model, we consider a portfolio of target and bystander customers and a loyalty program that may simultaneously motivate target customers to increase and bystander customers to decrease their purchases with the firm. Both customer groups' incremental profits reflect changes in their incremental sales due to the loyalty program, customer profit margins, and target and bystander sales levels:

$$P_T = PM_T \times (IS_T \times S_T) \text{ and} \quad (1)$$

$$P_B = PM_B \times (IS_B \times S_B), \quad (2)$$

where $P_{T/B}$ = average incremental profits of a target/bystander (\$),
 $PM_{T/B}$ = average net profit margin of a target/bystander in the firm (%),
 $IS_{T/B}$ = average incremental change in sales for a target/bystander due to program (%), and
 $S_{T/B}$ = average sales per target/bystander.

To evaluate the opposing effects of target and bystander customers on loyalty program performance, we offset the incremental profit from a target customer by the incremental profit (loss) from the customers who observe that target customer (number of bystanders \times incremental loss per bystander):

$$LPP = P_T + (N_B \times P_B), \quad (3)$$

where LPP = company's incremental loyalty program profits due to rewarding target, and
 N_B = number of bystanders per target.

Managers can apply this model to their loyalty programs. As an example, we use Study 1 results for a typical airline loyalty program as well as airline industry-typical values. First, we assume the firm rewards the most profitable 20% of its customers (Brierley 2012; Zeithaml, Rust, and Lemon 2001). Second, for both customer types, we use an average net profit margin of 1.5% for a customer in the airline industry (IATA 2010). Third, we employ average incremental sales of 13.25% for targets and -17.04% for bystanders (i.e., with medium rule clarity), as identified in Study 1. Fourth, we assume that the average target has 16 times more sales than an average bystander customer (i.e., $S_B = \$1000$, $S_T = \$16,000$; Koch 2005). The result of this analysis is graphically illustrated in Figure 3.

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Table 1
Selected Marketing Research on Customer Gratitude, Status, and Unfairness

Reference	Context	Theoretical Foundation	Key Findings
Customer gratitude			
Dawson 1988	Charitable giving	Reciprocity principle	Past benefits received and feeling of indebtedness (i.e., gratitude) provide motives for charitable giving.
Morales 2005	Department store, luggage store, apartment locator service	Reciprocity principle, attribution theory	Customers reward firms for extra effort: Gratitude mediates effects of the firm's effort on customers' behavior. Inferred persuasion motivations diminish the relationship.
Palmatier et al. 2009	Retail clothing, manufacturer of industrial products and services	Gratitude-based reciprocity	Gratitude mediates the effect of relationship investment on performance, along with trust and commitment. Relationship investments' effect on gratitude is positively moderated by customers' perceptions of seller's free will, benevolence, and customer's need for the investment.
Customer status			
Drèze and Nunes 2009	Hierarchical loyalty programs of retailers and hotel chains	Social comparison theory	The number of tiers positively affects elite customers' status perception; the number of customers in the elite tier negatively affects elite customers' status perception. Non-elite customers prefer multiple tiers.
Lacey, Suh, and Morgan 2007	Hierarchical loyalty program of department store chain	Concept of social status	Elevated customer status positively affects relationship commitment, increased purchases, share of customer, word of mouth, and customer feedback.
Wagner, Hennig-Thurau, and Rudolph 2009	Hierarchical loyalty programs of airline and department store chain	Concept of social status, prospect theory	The negative loyalty impact of status demotion is stronger than the positive loyalty impact of status elevation (negative asymmetry). The negative impact can be alleviated by increasing the locus of control and providing an apology.
Customer unfairness			
Darke and Dahl 2003	Electronics retailer	Equity theory, transaction utility theory	Consumers' evaluations of the price fairness depend on equity considerations when discounts are provided to some customers (high status regular customers versus spurious customers) but not to others.
Feinberg, Krishna, and Zhang 2002	Music download services	Equity theory	Consumer preferences for a firm are affected by the firm's overall price policy. Consumers prefer the firm less if it offers a price promotion to switchers (betrayal effect). Also, consumers prefer the firm less if another firm offers a price promotion to its own loyal customers (jealousy effect).
Samaha, Palmatier, and Dant 2011	Fortune 500 seller of diverse durable consumer goods	Equity theory, dynamic capabilities theory	Perceived unfairness acts as "relationship poison": It directly damages relationships, aggravates the negative effects of both conflict and opportunism, and undermines the benefits of contract utilization.

Table 2
Descriptive Statistics and Correlations

Construct	Study 1			Study 2		Study 3			Correlations				
	M	SD	AVE	M	SD	M	SD	AVE	1	2	3	4	5
1. Customer gratitude	4.23	1.67	.91	4.50	1.51	4.35	1.52	.92	.96/.97	.59**	-.47**	.70**	.44**
2. Customer status	3.56	1.78	.82	3.98	1.67	3.35	1.44	.73	.69**	.93/.87	-.15**	.47**	.33**
3. Customer unfairness	2.93	1.75	.80	2.41	1.55	2.52	1.53	.82	-.50**	-.39**	.95/.95	-.55**	-.35**
4. Customer loyalty	5.09	1.40	.83	5.39	1.22	4.99	1.45	.86	.66**	.52**	-.65**	.94/.95	.50**
5. Incremental sales	-1.95	26.89	N.A.	5.71	24.18	-2.27	28.45	N.A.	.50**	.47**	-.44**	.50**	N.A.

** $p < .01$

Notes: AVE = combined Study 1 and 2 average extracted variance; combined Study 1 and 2 (Study 3) correlations are reported below (above) the diagonal; Cronbach's alphas are reported on the diagonal (Combined Study 1 and 2/Study 3). N.A. = not applicable.

Table 3
Results: Effects of Loyalty Programs on Performance Outcomes

Structural Path	Hypothesis (Direction)	Study 1: Airlines		Study 2: Hotels		Study 3: Airlines	
		β	t-Value	β	t-Value	β	t-Value
<i>Hypothesized effects</i>							
Loyalty program target → customer gratitude	H _{1a} (+)	.55**	13.07	.20**	3.17	.36**	6.22
Loyalty program target → customer status	H _{1b} (+)	.61**	14.07	.36**	6.39	.46**	8.15
Loyalty program bystander → customer status	H _{2a} (-)	-.21**	-3.92	-.34**	-5.59	-.10*	-1.85
Loyalty program bystander → customer unfairness	H _{2b} (+)	.61**	12.89	.42**	7.47	.14*	2.01
Customer gratitude → customer loyalty	H _{3a} (+)	.20**	2.84	.16*	1.96	.34**	5.64
Customer gratitude → incremental sales	H _{3b} (+)	.13 [†]	1.58	.23**	2.90	.23**	3.91
Customer status → customer loyalty	H _{4a} (+)	.20**	3.55	-.01	-.12	.07 [†]	1.61
Customer status → incremental sales	H _{4b} (+)	.25**	3.65	.15*	1.74	.11*	1.87
Customer unfairness → customer loyalty	H _{5a} (-)	-.33**	-5.84	-.42**	-6.25	-.19**	-4.63
Customer unfairness → incremental sales	H _{5b} (-)	-.26**	-3.36	-.16**	-2.75	-.16*	-2.11
<i>Controls</i>							
Experience loyalty programs → customer gratitude		-.06	-1.23	.10*	1.82	.06	.82
Experience loyalty programs → customer status		-.04	-.64	.03	.81	-.04	-.65
Experience loyalty programs → customer unfairness		.02	.37	-.14**	-3.65	-.06	-.99
Experience airlines/hotels → customer gratitude		.04	.58	.02	.38	-.08	-.96
Experience airlines/hotels → customer status		.03	.45	.02	.49	-.03	-.44
Experience airlines/hotels → customer unfairness		.02	.30	-.01	-.12	.17*	1.91
Customer value → customer loyalty		.22**	3.54	.33**	3.90	.33**	6.44
Customer value → incremental sales		.09	1.11	.10	1.22	.09	1.38
Customer share of wallet → customer loyalty						.17**	4.24
Customer share of wallet → incremental sales						.07	1.23
R ² for customer gratitude		.31		.05		.13	
R ² for customer status		.56		.36		.26	
R ² for customer unfairness		.37		.20		.05	
R ² for customer loyalty		.64		.56		.68	
R ² for incremental sales		.36		.26		.24	

[†] $p < .10$, * $p < .05$, ** $p < .01$

Notes: β represents standardized path coefficient. Across all three studies, we use control groups and coding schemes to isolate the effects of loyalty programs on target and bystander customers. Thus, the path coefficients for the effect of loyalty program target (bystander) on customer gratitude, status, and unfairness can be interpreted as the differential effect of receiving a reward as a target customer (observing the target customer receive a reward as a bystander customer), compared with receiving nothing as a customer of a firm with no loyalty program.

Figure 1
Framework for Understanding the Effectiveness of Loyalty Programs

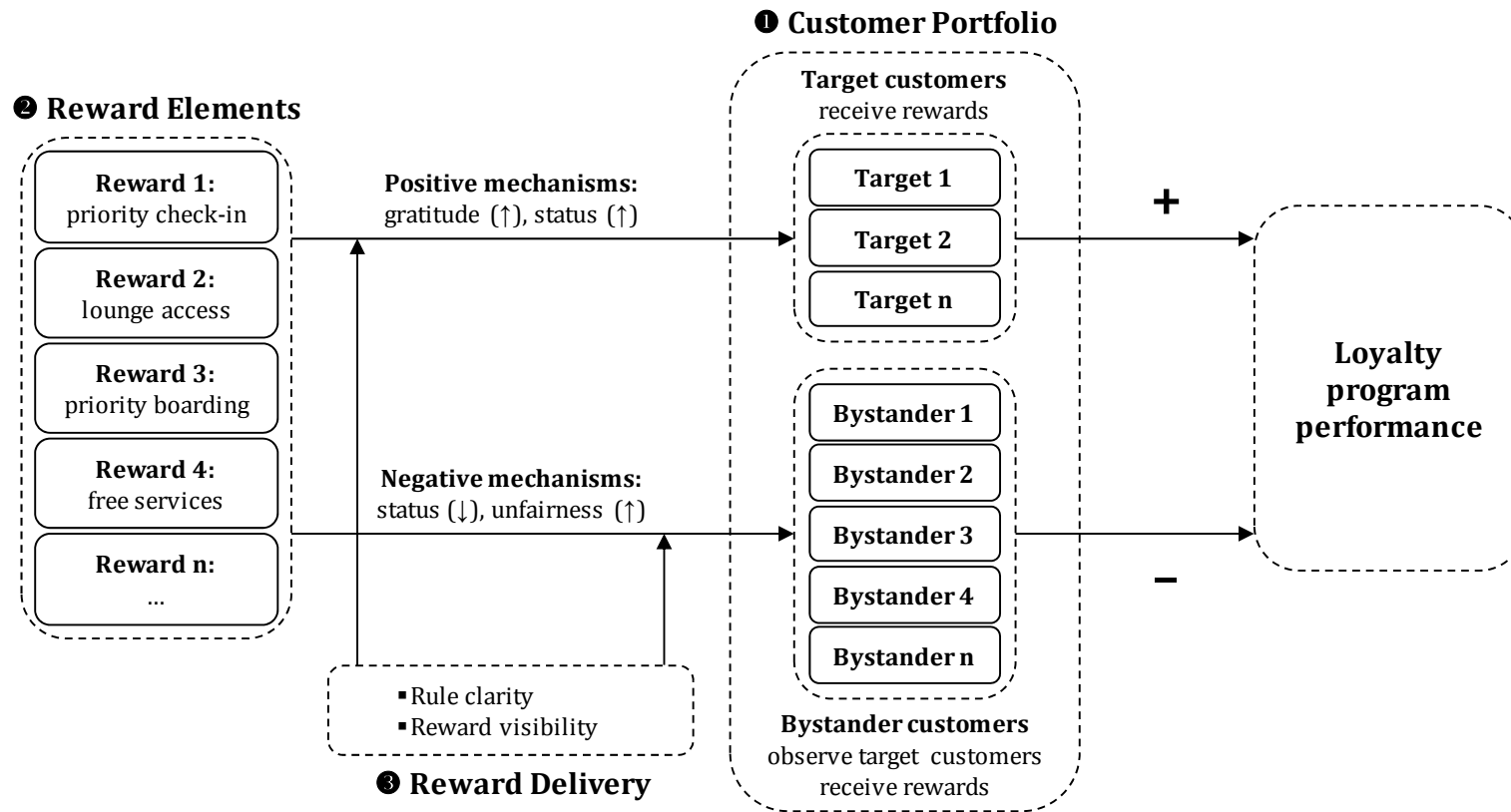


Figure 2

Conceptual Model of Loyalty Program Effects on Performance Outcomes

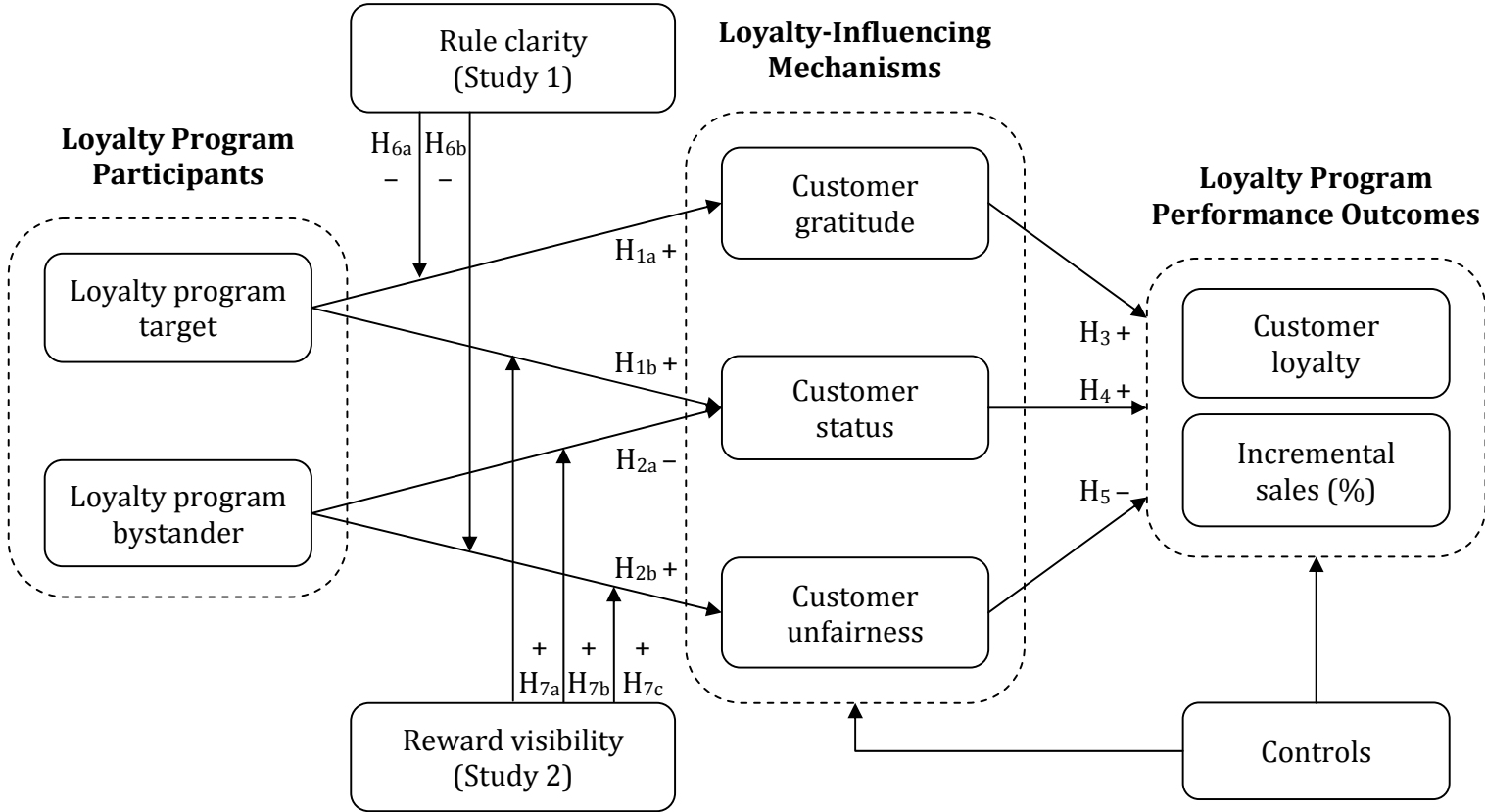


Figure 3

Customer Portfolio Analysis: Loyalty Program Performance for Different Bystander-to-Target Customer Ratios (Study 1)

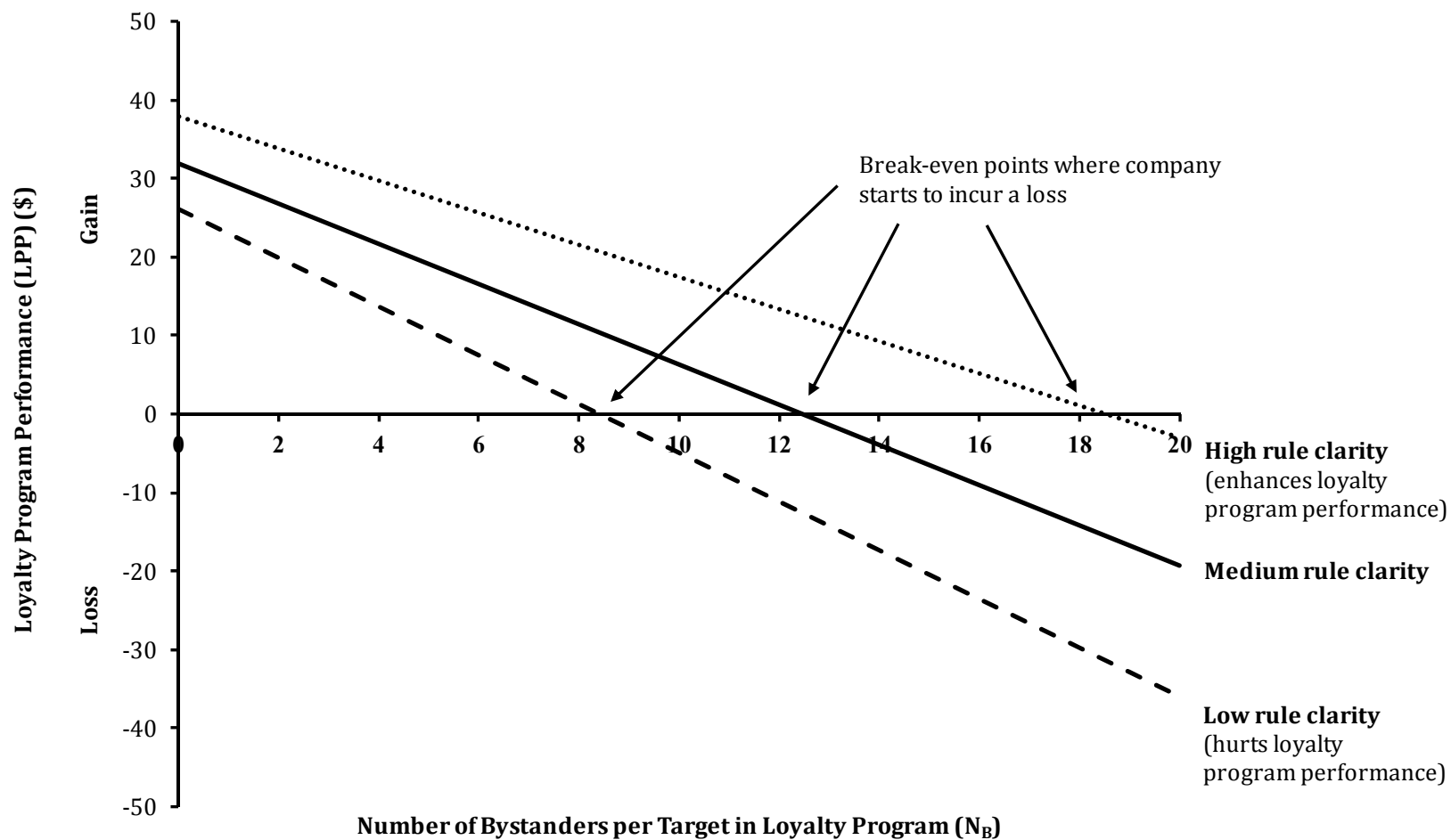
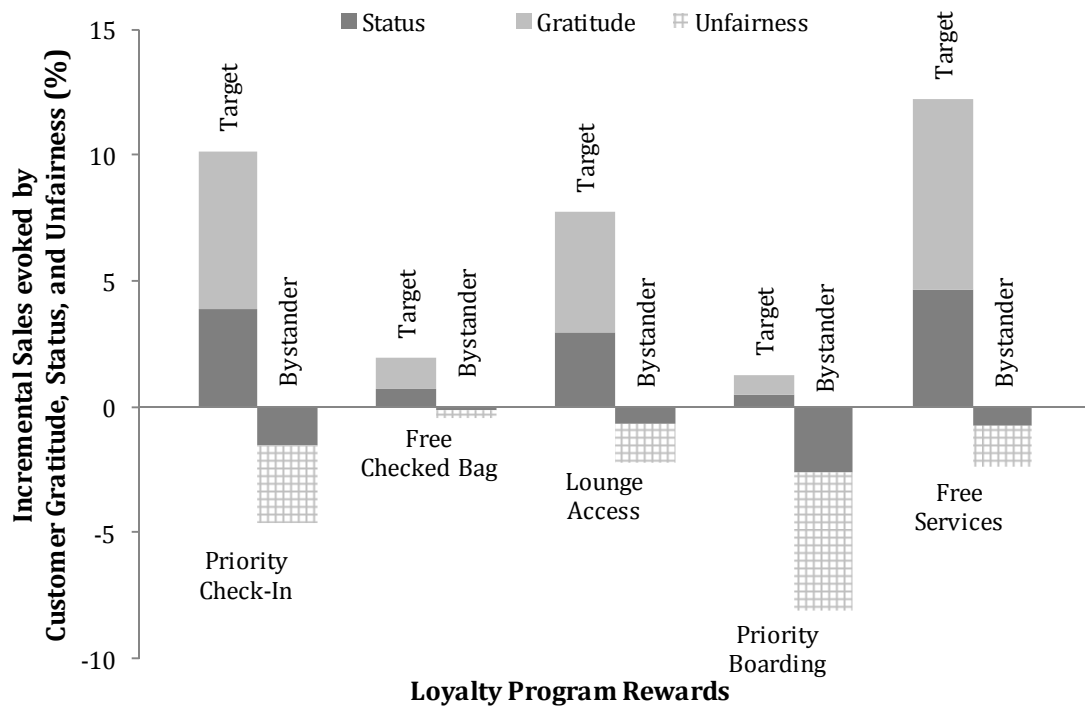


Figure 4

Reward Element Analysis: Incremental Sales for Different Program Rewards (Study 3)



Notes: For each of the five reward elements in Study 3, the left (right) stacked bar shows the total effect of that reward on target (bystander) customer's incremental sales. The different shading identifies the contribution to the total effect from customer gratitude (light gray), status (dark gray), and unfairness (crosshatched).