

The Long-Term Impact of Loyalty Programs on Consumer Purchase Behavior and Loyalty

Despite the prevalent use of loyalty programs, there is limited evidence on the long-term effects of such programs, and their effectiveness is not well established. The current research examines the long-term impact of a loyalty program on consumers' usage levels and their exclusive loyalty to the firm. Using longitudinal data from a convenience store franchise, the study shows that consumers who were heavy buyers at the beginning of a loyalty program were most likely to claim their qualified rewards, but the program did not prompt them to change their purchase behavior. In contrast, consumers whose initial patronage levels were low or moderate gradually purchased more and became more loyal to the firm. For light buyers, the loyalty program broadened their relationship with the firm into other business areas. The findings suggest a need to consider consumer idiosyncrasies when studying loyalty programs and illustrate consumers' cocreation of value in the marketing process.

As an important component of firms' customer relationship management (CRM) strategy, loyalty programs aim to increase customer loyalty by rewarding customers for doing business with the firm. Through these programs, firms can potentially gain more repeat business and, at the same time, obtain rich consumer data that aid future CRM efforts. Since American Airlines launched the first contemporary loyalty program in 1981, loyalty programs have blossomed and now span various industries, including retail, travel, and financial industries. It is estimated that more than half of U.S. adults are enrolled in at least one loyalty program (Kivetz and Simonson 2003).

Despite the prevalent use of loyalty programs, their effectiveness is not well understood (Bolton, Kannan, and Bramlett 2000). Some researchers question the value of loyalty programs. For example, Dowling (2002) suggests that loyalty programs do not necessarily foster loyalty and are not cost effective and that the proliferation of loyalty programs is a hype or a "me-too" scheme. Conversely, some recent studies show that loyalty programs have a positive impact on consumers' repatronage decisions and their share of wallet (e.g., Lewis 2004; Verhoef 2003). With limited empirical validations, the debate on whether loyalty programs are truly effective continues. The divergent views suggest a need to understand these programs better. This is also of strategic importance because such programs are

costly investments and require a firm's long-term commitment. It is vital for managers to know whether and how these programs work before they take the plunge.

This research contributes to a better understanding of loyalty programs in three ways. First, although evidence about the effectiveness of loyalty programs has begun to accumulate recently, the field is still underdeveloped, and a clear picture has yet to emerge. Addressing this issue, Bolton, Kannan, and Bramlett (2000, p. 28) suggest that "to determine the long-term efficacy of a loyalty rewards program, a company must quantify the program's influence on future purchase behavior (e.g., usage levels)." The current research responds to the suggestion by quantifying on a large scale the effectiveness of a loyalty program in the convenience store industry. The key research question is whether loyalty programs change consumers' patronage levels and exclusive loyalty to the firm. These outcomes are important to study because they are directly related to consumer profitability and the financial success of a loyalty program.

Second, this research examines consumers' longitudinal behavior change after they join a loyalty program. Given the long-term orientation of loyalty programs and their transformation of single purchases into multiperiod decisions (Kopalle and Neslin 2003), it is natural that their effectiveness should be examined longitudinally. Methodologically, studying loyalty programs over time alleviates self-selection bias. Because loyalty program members may already be frequent customers who are more likely to find the program attractive, simply comparing the behavior of loyalty program members with that of nonmembers cannot establish a conclusive causal relationship (Leenheer et al. 2003). Thus, examining dynamic behavior change is more powerful than cross-sectional studies of behavior at a certain point in time (Verhoef 2003). However, relatively few published empirical studies have examined longitudinal loyalty program effects, especially from the perspective of

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continuous loyalty programs. This leaves a gap in the understanding of the true effects of such programs. A recent study by Lewis (2004) has advanced this area by examining dynamic postreward effects on consumer behavior in the context of a continuous loyalty program. The current research extends this work by studying the general effects of such a loyalty program on long-term purchase behavior change.

Third, this research studies how the idiosyncrasies of individual consumers influence behavior changes that occur after they join a loyalty program. Previous research has shown that the idiosyncratic fit of an individual with a loyalty program can influence his or her likelihood of joining the program (Kivetz and Simonson 2002). However, it is not clear whether such effects would carry over to how these consumers change their purchase patterns after program enrollment. Adding to the limited set of individual idiosyncrasies that have been examined in the literature, the current research explores how consumers with different initial usage levels change their behavior to maximize the benefits they receive from a loyalty program.

Are Loyalty Programs Effective?

Definition

Loyalty program. In this article, a “loyalty program” is defined as a program that allows consumers to accumulate free rewards when they make repeated purchases with a firm. Such a program rarely benefits consumers in one purchase but is intended to foster customer loyalty over time. Thus, promotions that work as “one-shot deals,” such as instant scratch cards, are not considered loyalty programs here. This exclusion is appropriate because these one-time promotions do not create the same customer lock-in as true loyalty programs (Sharp and Sharp 1997).

Consumer loyalty. This research adopts Oliver’s (1999, p. 34) definition of consumer loyalty as “a deeply held commitment to rebuy or repatronize a preferred product/service consistently in the future.” According to Oliver, consumer loyalty can occur at four different levels: cognitive, affective, conative, and behavioral. Although all four facets of consumer loyalty are important, the current research focuses on behavioral loyalty. This aspect of consumer loyalty has not been thoroughly examined in previous research, even though it has a direct impact on a firm’s bottom line and facilitates the assessment of loyalty program profitability (and, relatedly, the decision to invest in such a program or to expand or terminate an existing program).

Loyalty Programs and Value Enhancement

Loyalty programs are often considered value-sharing instruments and can enhance consumers’ perceptions of what a firm has to offer (Bolton, Kannan, and Bramlett 2000; Yi and Jeon 2003). This value enhancement function is important because the ability to provide superior value is instrumental to customer relationship initiation and retention (Sirdeshmukh, Singh, and Sabol 2002; Woodruff 1997). Indeed, enhanced value perception is considered a necessary condition to a loyalty program’s success (O’Brien and Jones 1995).

Loyalty programs provide value to consumers in two stages. In the first stage, program points are issued to consumers at the time of purchase. Although these points have no practical value until they are redeemed, recent studies show that they have important psychological meaning to consumers (Hsee et al. 2003; Van Osselaer, Alba, and Manchanda 2004). The psychological benefit increases the transaction utility of a purchase (Thaler 1985) and, subsequently, the overall value perception of doing business with the firm. Because consumers can later redeem points for free rewards, point accumulation creates an anticipation of positive future events, which increases consumers’ likelihood of staying in the relationship (Lemon, White, and Winer 2002).

In the redemption stage, consumers receive both psychological and economic benefits from a loyalty program. The free reward functions as a positive reinforcement of consumers’ purchase behavior and conditions them to continue doing business with the firm (Sheth and Parvatiyar 1995). Psychologically, giving free rewards to customers shows the firm’s appreciation and personal recognition of its customers. This sense of being important can enhance consumers’ overall sense of well-being and deepen their relationship with the firm (Bitner 1995; Gwinner, Gremler, and Bitner 1998). Some researchers suggest that there are other psychological benefits as well, such as the opportunity to indulge in guilt-free luxuries (Kivetz and Simonson 2002) and a sense of participation (Dowling and Uncles 1997), which may be especially appropriate for brands that do not carry this belongingness (Oliver 1999). All these psychological and economic benefits translate into an attractive value proposition from the firm.

Loyalty Programs and Relationship Commitment

Beyond the need for superior value, a necessary condition for any relationship to develop is the commitment of both parties in the relationship (Morgan and Hunt 1994). Given a wide variety of choices and a low switching barrier, it is easy for today’s consumers to switch among different firms. This poses significant threats to customer relationships because consumers are not likely to commit to a single brand or firm. Loyalty programs can alleviate this lack of commitment and reduce customer defection by raising switching costs. Because loyalty programs reward customers for their repeated patronage, consumers tend to focus their purchases in one program to maximize the benefits they receive (Sharp and Sharp 1997). Such vested interests in a program make it difficult for competitors to entice customers away from a firm. Using game-theoretic models, Kim, Shi, and Srinivasan (2001) demonstrate that such a competitive barrier benefits the firm and results in higher prices in the marketplace. This is especially true for high-variety-seeking products and services (Zhang, Krishna, and Dhar 2000).

Loyalty programs not only help build customer commitment but also demonstrate a firm’s commitment. It is often costly for firms to initiate and maintain a loyalty program. It requires extensive efforts to manage point records and reward issuance. After such a program is in place, it is usually difficult to terminate it without risking the loss of con-

sumers' goodwill. Although a loyalty program brings real cost to the business, it also shows the firm's commitment to establishing a long-term relationship with its customers. Such a commitment and demonstration of goodwill can further deepen the relationship between the firm and its customers.

Empirical Evidence of the Effectiveness of Loyalty Programs

Lab and field studies have examined whether loyalty programs indeed positively affect consumers. Although both types of research are important, this section focuses on empirical examinations of real loyalty programs based on actual consumer behavior because they are most closely related to the current research. Existing studies in this area can be classified into three categories depending on the comparison base on which conclusions are drawn.

Comparison across competitors. The first group of studies quantifies the impact of loyalty programs by comparing them across multiple firms. The focal variables are usually market share or share of wallet. Using consumer panel data of grocery purchases, both Mägi (2003) and Leenheer and colleagues (2003) find mixed support for the positive effects of loyalty programs on share of wallet. Leenheer and colleagues' study reveals increased share of wallet for four of seven programs and offers support for the use of accumulated rewards (as opposed to price discounts) in loyalty programs. Mägi finds that loyalty program membership increases a consumer's share of wallet and store visit and decreases shares for competitors. However, this is supported only at the chain level, not at the store level. Focusing on the airline industry, both Kopalle and Neslin (2003) and Nako (1992) conclude that frequent-flier programs enhance the value of an airline's products and increase consumer demand for airlines that offer such programs.

Within this same category of research but focusing on a different behavioral variable, Sharp and Sharp (1997) investigate the impact of Australia's Fly Buys program by comparing observed purchase frequencies with the Dirichlet baseline and find only a weak improvement in repeat-purchase behavior for most stores. Using a similar approach, Meyer-Waarden and Benavent (2006) find only mixed effects of the loyalty programs offered by several French grocery retailers. Because members of the Fly Buys program can earn loyalty points across stores, it can be argued that such a multistore loyalty program fosters loyalty toward the program rather than toward any particular store and may even encourage consumers to divide their loyalty among multiple firms (Dowling and Uncles 1997). This limits the generalizability of the findings. Moreover, rewards offered by the Fly Buys program (free air travel or lodging) are unrelated to actions consumers need to take (patronizing retail stores) to accumulate points. Recent research suggests that this type of program may elicit reactance from consumers and reduce their intrinsic motivation to engage in the original purchase activities (Kivetz 2005).

Comparison across consumers. The second type of existing research compares the behavior of loyalty program members with that of nonmembers to identify the impact of loyalty programs. Both Verhoef (2003) and Bolton, Kannan,

and Bramlett (2000) examine the effectiveness of loyalty programs in the financial industry. Verhoef finds that participation in an insurance firm's loyalty program makes consumers more likely to stay with the firm and encourages them to expand their business with the firm. Bolton, Kannan, and Bramlett offer a more in-depth examination of this issue by studying the moderating effect of a credit card firm's loyalty program on the relationship between consumers' service experiences and their subsequent behavior. They find that program members weigh negative experiences less in their repatronage decisions than nonmembers. This is consistent with the proposition that loyalty programs form competitive barriers between firms and allow firms to enjoy their customers more exclusively. Bolton, Kannan, and Bramlett do not find a significant main effect of loyalty program membership on customer retention, but their results show that loyalty program members used their credit cards more than nonmembers.

As mentioned previously, studies comparing loyalty program member and nonmember behavior are subject to self-selection bias. That is, the differences between members and nonmembers may exist before the program rather than being a result of the program. This makes it difficult to establish the direction of the causal relationship, prompting researchers to suggest the appropriateness of studying dynamic behavior change instead (Lewis 2004; Verhoef 2003).

Comparison across time. The third category of studies remedies self-selection bias by studying the same consumers' behavior across time. A majority of these studies focus on short-term loyalty programs. A typical setting is an N-week turkey/ham supermarket reward program in which consumers need to spend over a set amount each week for N weeks to receive a free turkey or ham (e.g., Lal and Bell 2003; Taylor and Neslin 2005). Studies find general support for such programs in terms of increased spending levels. Drèze and Hoch (1998) further conclude that a loyalty program targeting a specific product category not only increases spending in the focal product category but also increases store traffic and overall spending in all categories.

When studying behavior changes over time, researchers suggest two types of effects: a short-term point pressure effect and a long-term rewarded behavior effect (Taylor and Neslin 2005). The point pressure effect represents a temporary shock in spending as consumers increase their purchase levels to qualify for a reward, analogous to the artificial increase in sales during a promotion. Drawing on the goal-gradient hypothesis, Kivetz, Urminsky, and Zheng (2006) find that this point pressure effect increases as consumers get closer to a reward, resulting in purchase acceleration. However, they also find that after the reward is obtained, the positive change in behavior dissipates, similar to the sales dip after a promotion. In contrast, the rewarded behavior effect refers to long-term sustained purchase increase, which can be a result of factors such as appreciation of the reward received and stronger loyalty toward the firm.

These two effects manifest differently in short-term and continuous loyalty programs (e.g., frequent-flier programs). Short-term programs are analogous to sales promotion and signify firms' temporary commitment. They create a pri-