

# Does Customer Demotion Jeopardize Loyalty?

Hierarchical loyalty programs award elevated customer status (e.g., “elite membership”) to consumers who meet a predefined spending level. However, if a customer subsequently falls short of the required spending level, firms commonly revoke that status. The authors investigate the impact of such customer demotion on loyalty intentions toward the firm. Building on prospect theory and emotions theory, the authors hypothesize that changes in customer status have an asymmetric negative effect, such that the negative impact of customer demotion is stronger than the positive impact of status increases. An experimental scenario study provides evidence that loyalty intentions are indeed lower for demoted customers than for those who have never been awarded a preferred status, meaning that hierarchical loyalty programs can drive otherwise loyal customers away from a firm. A field study using proprietary sales data from a different industry context demonstrates the robustness of the negative impact of customer demotion. The authors test the extent to which design variables of hierarchical loyalty programs may attenuate the negative consequences of status demotions with a second experimental scenario study and present an analytical model that links status demotion to customer equity to aid managerial decision making.

*Keywords:* loyalty programs, customer demotion, customer loyalty, prospect theory, relationship marketing

Companies in the United States spend more than \$1.2 billion on customer loyalty programs per year, and the average household belongs to 12 of such programs (Ferguson and Hlavinka 2007; Kumar 2008). Hierarchical loyalty programs award preferred customer status (e.g., “elite membership”), providing exclusive benefits to consumers who have exceeded a certain spending level. Such programs are common in many service industries, including airlines (e.g., Continental), banking (e.g., UBS), department store retailing (e.g., Neiman Marcus), and hotels (e.g., Marriott).

To maintain preferred customer status, elevated consumers usually must maintain high levels of spending with the company (Kumar and Shah 2004), but what happens when a customer falls short of the company’s expectations and therefore loses his or her preferred status? That is, what happens when the customer is “demoted” by the company? Service firms that run hierarchical loyalty programs demote thousands of customers every day (Reed 2005), but the full ramifications of such systematic customer status reductions

remain unclear. Whereas disciplines such as sociology (Garfinkel 1956) and organizational psychology (Gephart 1978) have long recognized status demotion as an important research issue, no existing marketing research has considered the effects of status reductions of consumers. This lack of research has particular importance because arguments from prospect theory and emotions theory suggest that customer demotion has the potential to destroy healthy customer relationships. Specifically, we theorize that customer demotion reduces loyalty intentions toward a firm to a level that is lower than the level of loyalty intentions the customer held before being elevated to preferred status. We present the psychological mechanisms through which this destructive effect takes place and test them through an experimental investigation using the scenario method and a field study based on proprietary company data from a different industry context. We test whether certain loyalty program design variables limit the destructive effect caused by customer demotion with a second scenario experiment and analytically link our findings to the strategic variable of customer equity.

## Status Demotion Research

Status, or the position or rank in a certain group awarded to a person by others (Packard 1959), is a strong motivator of human behavior (Frank 1985). Elevated levels of status correspond to a set of exclusive rights and benefits, which often provoke respect, consideration, or envy from others (Csikszentmihalyi and Rochberg-Halton 1981). The phenomenon of status demotion initially emerged as a relevant research topic among sociologists and anthropologists and was first recognized by Garfinkel (1956), who coined the term “status degradation ceremony” to refer to the commu-

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nication of a status reduction to the affected person (Finkelstein 1996; Young 1965). Some 20 years later, Gephart (1978) became the first organizational behavior scholar to address the topic. Employing an ethnomethodological approach, he investigated the demotion process in relation to organizational succession. Since then, other scholars have studied status reductions in organizations and have found that demotion constitutes a critical incident, followed by the experience of negative affect and “withdrawal behaviors” (e.g., decreasing loyalty to the organization) by the demoted consumers (e.g., Pfeffer 1981; Trice and Beyer 1984). Although the impact of preferential customer treatments on loyalty has emerged as an urgent research topic in the marketing discipline (e.g., Dreze and Nunes 2007; Wangenheim and Bayon 2007), we are not aware of a single study that examines the demotion of customers and their reactions to it.

## How Customer Demotion Affects Loyalty Intentions

In hierarchical loyalty programs, introducing preferential customer treatment provides additional benefits to customers, which should increase their loyalty intentions toward the firm (Lacey, Suh, and Morgan 2007). Intuitively, withdrawing preferred customer status and the benefits associated with it then should cause the customer to return to his or her original level of loyalty intentions. However, arguments from both prospect and emotions theory suggest that such withdrawal can cause negative effects, which in turn can drive an otherwise loyal customer away from the firm.

### *A Prospect Theoretical Perspective on Customer Demotion*

Prospect theory helps explain asymmetries in people’s evaluations and behaviors relative to their perceived losses or gains in conditions of perceived uncertainty (Kahneman and Tversky 1979). It builds on the principle that human perception tends to be related to changes in or differences among certain conditions instead of their absolute magnitude; it also assumes that people regard given outcomes either as losses or as gains relative to a certain reference point (Qualls and Puto 1989). A key element of prospect theory entails the loss aversion bias, which states that people tend to be more sensitive to changes they perceive as losses than to equally strong changes they interpret as gains (Ho, Lim, and Camerer 2006; Thaler 1980). According to a prospect theoretical perspective, an increase in customer status constitutes a gain for the awarded customer because the customer receives certain benefits to which he or she had no access before the status elevation. Such benefits include convenience (e.g., personal assistance by courteous service personnel instead of automated service kiosks or telephone help lines) and recognition (e.g., giving customers “the ability to feel special”; Shugan 2005, p. 190). However, the withdrawal of a customer’s preferred status because of a reduced spending level represents a loss for the customer relative to his or her reference point, that is, the previously held status (Knetsch 1989). After such a demo-

tion, the customer can no longer access the additional benefits that correspond to elevated status. Prospect theory’s loss aversion bias suggests that status demotion (i.e., the loss of customer status and its exclusive benefits) should be more influential for human judgments and future behavior—namely, customer loyalty intentions—than equally strong gains (i.e., the initial increase in customer status and the associated benefits) (Ho, Lim, and Camerer 2006). Accordingly, we expect that status demotion exerts an asymmetric negative effect on customer loyalty intentions, such that the negative effect of status decreases on loyalty intentions demonstrates a stronger magnitude than the positive effect of status increases. In other words, members of loyalty programs who lose their previously elevated customer status and return to the customer status they had before their elevation will demonstrate lower loyalty intentions than not only members who maintain their elevated customer status (i.e., experienced a gain but no loss) but also members whose status never increased in the first place (i.e., experienced neither a gain nor a loss).

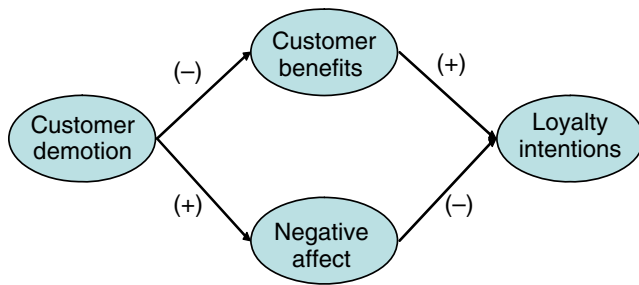
### *An Emotion Theoretical Perspective on Customer Demotion*

As a cognitive theory originating in behavioral economics, prospect theory elides the potential effect of emotional reactions to status changes. However, a status demotion also conveys to the customer that he or she has not performed to meet the company’s expectations and is no longer part of the company’s “inner circle” (Trice and Beyer 1984). Such an unpleasant experience is likely to elicit the experience of negative emotional states, such as anger and disappointment (Fournier, Dobscha, and Mick 1998; Lazarus 1991). This argument is in line with demotion research in organizational psychology and sociology, which indicates that status reductions commonly cause negative emotions within the person who loses status (e.g., Smith 2002). Building on extensive research that demonstrates the destructive effects of negative emotions on customer attitudes and behaviors (e.g., Bougie, Pieters, and Zeelenberg 2003), we propose that the negative emotions triggered by demotion will translate into reduced customer loyalty intentions, strengthening the negative effect caused by the withdrawal of benefits captured by the loss aversion bias.

In summary, arguments from prospect and emotions theory lead to us expect that customer demotion will have an asymmetric negative impact on customer loyalty intentions. Furthermore, we argue that customers’ greater sensitivity to a loss of benefits than to a gain of the same benefits, combined with the negative affect caused by the demotion act, represents the psychological mechanism through which demotion reduces loyalty intentions. We illustrate this rationale in Figure 1 and summarize it in our first two hypotheses:

- H<sub>1</sub>: Customer demotion exerts a negative asymmetric effect on customer loyalty intentions; decreases in loyalty intentions caused by status reductions have a greater magnitude than increases caused by status elevations.
- H<sub>2</sub>: Customer demotion decreases customer loyalty intentions through (a) decreased perceptions of experienced benefits and (b) increased levels of negative affect.

**FIGURE 1**  
**Structural Model of the Psychological**  
**Mechanisms Between Demotion and Loyalty**  
**Intentions**



## Study 1: Testing the Effect of Customer Demotion on Loyalty Intentions with a Laboratory Experiment

### Methodology

*Context and dramaturgy.* We test the proposed effects of customer demotion in the context of airlines' frequent-flier programs (see Dreze and Nunes 2004). This industry context is appropriate because differentiation in customer status is a widespread marketing practice among airlines. We conduct an experimental scenario study with three different service scenarios, corresponding to a nested between-groups design in which the scenarios vary on two factors: status elevation and status demotion. A status reduction implies that the customer has been awarded elevated status previously, so status demotion represents a nested factor within the elevated condition. Consequently, the three experimental groups are as follows: (1) a stable-status group (no elevation, no demotion), (2) an elevated-status group (elevation, no demotion), and (3) a demoted-status group (elevation, demotion).

Scenario methods, which ask participants of experiments to imagine themselves in hypothetical constellations and roles, are designed to provide insight into social psychological responses to hypothetical situations and have proved ideal for such constellations (Kwon and Weingart 2004). In this specific case, each of our three scenarios asks participants to envision themselves as long-term customers of the fictitious airline Premier Air. We assigned respondents randomly to one of the three customer status scenarios, in line with Dreze and Nunes's (2007) recommendation. To provide realistic experimental manipulations, we reviewed existing hierarchical loyalty programs to determine the benefits they offer customers with elevated status. We found that convenience and recognition benefits are among the most widely used in the airline industry, and therefore we focus on these benefits. We also studied the formal conditions of elevated customer membership in the airline industry and designed our manipulations accordingly. At the beginning of the experiment, participants in all three experimental groups reviewed background information about Premier Air and their relationship with the air-

line. We required all participants to be active members of at least one frequent-flier program in real life. We offered no further information to the stable-status group but presented the elevation manipulation to the elevated- and demoted-status groups. Finally, for the demoted group only, we provided the demotion manipulation. We report all manipulations in Appendix A.

*Measures.* After presenting the background information and manipulations, we asked participants to rate their perceptions of the convenience and recognition benefits offered by Premier Air, their experience of negative affect, and their loyalty intentions (Agustin and Singh 2005). We adopt reflective multi-item measures for all latent variables from the extant literature and slightly modify them to fit the purpose of the current research; all items appear in Appendix B. Furthermore, the questionnaire includes manipulation and realism check items.

*Sample.* We applied a data collection procedure similar to that which Tokman, Davis, and Lemon (2007) use. Specifically, students in undergraduate marketing classes at a major public university in the southwestern United States solicited participants according to a provided list of criteria and directed them to a Web site that contained the scenario descriptions and questionnaire. The quota character is an accepted characteristic for experimental research (Hennig-Thurau et al. 2006). Students received extra credit for their contribution. Participants were incentivized by being entered into a free drawing to win one of ten \$30 gift certificates for the online retailer Amazon.com. Each participant in the experiment agreed to be called if they won the drawing or for personal validation. Contacting the winners of the drawing and a set of random participants indicated no problematic responses. Our final sample included 359 participants; their average age was 45 years, 53% were women, and 49% had experienced college education.

### Manipulation and Realism Checks

We record the effectiveness of our manipulation of status elevation with two items ("At one point, I was elevated to a higher customer status," and "At one point, I was given a preferred customer status by Premier Air") measured on seven-point scales ranging from "absolutely false" (1) to "absolutely true" (7) ( $\alpha = .88$ ). An analysis of variance (ANOVA) of the composite score supports the effectiveness of the status elevation manipulation ( $M_{\text{elevation}} = 5.96$ ,  $M_{\text{no elevation}} = 4.59$ ;  $F(1, 357) = 59.03$ ,  $p < .001$ ).<sup>1</sup> Likewise, we test our status demotion manipulation using three items: "My status as a customer was degraded," "My status as a customer was demoted," and "My status as a customer was reduced" ( $\alpha = .92$ ). Again, the manipulation is successful ( $M_{\text{demotion}} = 5.02$ ,  $M_{\text{no demotion}} = 2.35$ ;  $F(1, 357) = 218.73$ ,  $p < .001$ ). We find no significant effect of the status demotion manipulation on the respondents' elevation perceptions ( $M_{\text{demotion}} = 6.09$ ,  $M_{\text{no demotion}} = 5.75$ ;  $F(1, 245) = 3.58$ , not significant) and thus rule out confounding effects.

<sup>1</sup>An explanation for the relatively high mean value in the non-elevated condition is that, to some extent, respondents may consider participation in the loyalty program per se one form of a status advantage (compared with nonmembers of the program).

To investigate the realism of our experimental design, we also include two “realism check” items (Darley and Lim 1993) in the questionnaire, using the same scales (“I could imagine an actual airline doing the things described in the situation earlier,” and “I believe that the described situation could happen in real life,”  $\alpha = .90$ ). The responses to these items reflect a sufficient level of realism of the employed manipulations ( $M_{\text{composite score}} = 5.43$ ,  $SD = 1.51$ ).<sup>2</sup>

### Validity Assessment

We conduct a confirmatory factor analysis using LISREL 8.71 to assess the measurement properties of our scales for convenience benefits, recognition benefits, negative affect, and loyalty intentions. The results indicate a good overall fit of the model ( $\chi^2(95) = 173.42$ ,  $p < .001$ ; root mean square error of approximation = .04; nonnormed fit index = .99; and comparative fit index = .99), as well as solid psychometric properties of the measures. Specifically, all standardized factor loadings exhibit statistical significance at  $p < .001$ , which indicates convergent validity. Factor magnitudes range from .69 to .97 and demonstrate positive signs. Evidence of internal consistency stems from composite reliability (values ranging from .90 to .97), alpha scores (.90 to .97), and average variance extracted (AVE; .69 to .89). We also achieve discriminant validity according to Fornell and Larcker’s (1981) suggested criterion because the AVE is greater than the squared correlation for each pair of factors. We provide the descriptive information and bivariate correlations in Table 1.

### Results

To assess the proposed overall asymmetric effect of customer demotion on loyalty intentions, we compare the three groups, which differ in terms of initial and final elevated status (i.e., stable, elevated, and demoted status), akin to the procedures that Strahilevitz and Loewenstein (1998) demonstrate. We employ a set of corresponding ANOVAs to compare the size of the effects caused by status elevations

and reductions to provide evidence for the asymmetric nature of the overall effect (e.g., Sen and Bhattacharya 2001). In a first step, an integrative analysis with all three groups reveals that the differences in the loyalty intentions means are highly significant ( $F(2, 356) = 43.80$ ,  $p < .001$ ). More specifically, although status elevations exert a positive impact on loyalty intentions ( $M_{SS} = 5.38$ ,  $M_{ES} = 5.84$ ;  $F(1, 212) = 5.55$ ,  $p < .05$ ), the negative impact of demotions appears to be much more pronounced ( $M_{ES} = 5.84$ ,  $M_{DS} = 4.09$ ;  $F(1, 245) = 77.57$ ,  $p < .001$ ), demonstrating asymmetric characteristics. Moreover, the findings suggest that demoted customers’ loyalty intentions are significantly lower than those of customers whose status never increased in the first place ( $M_{SS} = 5.38$ ;  $F(1, 257) = 39.33$ ,  $p < .001$ ). These results fully support  $H_1$  and suggest that though elevated customer status increases customers’ loyalty intentions as companies hope, demoted customers exhibit substantially lower loyalty intentions than customers who have never experienced a status increase.

In the next step, we investigate the psychological mechanisms through which status demotions may reduce customer loyalty intentions. Following the advice of Bagozzi and Yi (1994), we apply the distribution-free approach of partial least squares (PLS) structural equation modeling to analyze our experimental data.<sup>3</sup> We use Smart-PLS 2.3 to conduct the analysis. We create two subsamples to provide evidence of the proposed relationships from different conceptual angles. The first subsample comprises demoted- versus elevated-status respondents (but excludes members of the stable-status group), whereas the second subsample contains demoted-status and stable-status (but not elevated-status) respondents. To determine the statistical significance of the parameter estimates, we generate  $t$ -values with a nonparametric bootstrapping procedure. We generate 500 resamples, all of which are the size of the original observations (Efron 2000). Table 2 summarizes the estimation results for both subsample comparisons.

Comparing demoted- and elevated-status customers, we find that status demotion exerts a strong negative effect on both convenience benefits ( $\gamma = -.52$ ,  $t = -11.47$ ) and recognition benefits ( $\gamma = -.37$ ,  $t = -6.75$ ). In other words, customers’ benefit perceptions are lower after a demotion. Similarly, status demotion strongly increases customers’ experience of negative affect ( $\gamma = .57$ ,  $t = 12.64$ ). Regarding the impact of benefits and emotions on loyalty intentions, we find that convenience benefits ( $\beta = .23$ ,  $t = 3.63$ ) and negative affect ( $\beta = -.53$ ,  $t = -9.68$ ) influence loyalty intentions, whereas the path coefficient from recognition benefits to loyalty intentions is positive but insignificant ( $p < .05$ ). To determine whether the benefits and negative affect fully mediate demotion’s impact on customer loyalty intentions or whether other phenomena also influence it, we estimate a rival model with an additional direct path from customer demotion to loyalty intentions (Iacobucci, Saldanha, and

<sup>2</sup>A postexperimental inquiry yielding 82 additional qualitative responses regarding participants’ perceived purpose of the experiment indicates that demand artifacts are of no relevant concern for this research. Detailed information on this inquiry is available on request.

**TABLE 1**  
**Study 1: Correlation Matrix (n = 359)**

	M (SD)	DEM	CB	RC	AFF	LOY
Customer demotion (DEM)	N.A.	1				
Convenience benefits (CB)	4.81 (1.82)	-.43	1			
Recognition benefits (RC)	3.12 (1.64)	-.31	.53	1		
Negative affect (AFF)	2.83 (2.07)	.54	-.38	-.24	1	
Loyalty intentions (LOY)	4.99 (1.72)	-.43	.50	.36	-.61	1

Notes: All correlations are significant at  $p < .01$  (two-tailed). N.A. = not applicable.

<sup>3</sup>All structural models, including rival models, were also estimated with covariance-based structural equation modeling using LISREL 8.71. Both methods, PLS and LISREL, lead to identical findings in terms of the (in)significance of parameter estimates and their signs. Neither method provides higher or lower estimates or  $t$ -values than the other one.

**TABLE 2**  
**Study 1: Path Coefficients from PLS Analysis**

		Effects on Cognitive and Affective Consequences					
Dependent Variable	Structural Path	Estimate		t-Value		R <sup>2</sup>	
		Demoted Versus Elevated Subsample	Demoted Versus Stable Subsample	Demoted Versus Elevated Subsample	Demoted Versus Stable Subsample	Demoted Versus Elevated Subsample	Demoted Versus Stable Subsample
Convenience benefits	Demotion → convenience benefits	-.52**	-.32**	-11.47	-5.78	.27	.10
Recognition benefits	Demotion → recognition benefits	-.37**	-.29**	-6.75	-4.80	.13	.09
Negative affect	Demotion → negative affect	.57**	.49**	12.64	9.88	.33	.24
		Effects of Loyalty Intentions					
Loyalty intentions	Convenience benefits → loyalty intentions	.23**	.21**	3.63	3.16	.52	.40
	Recognition benefits → loyalty intentions	.08	.13*	1.58	2.15		
	Negative affect → loyalty intentions	-.53**	-.48**	-9.68	-8.81		

\* $p < .05$  (two-tailed).  
\*\* $p < .01$  (two-tailed).

Deng 2007). The added path is insignificant ( $t = .95$ ), providing evidence for full mediation and support for H<sub>2</sub>.

The results remain similar when we compare demoted- and stable-status customers. All the path coefficients point in the same directions, and all significant paths from the first analysis are also significant here. The only difference is that the relationship between recognition benefits and loyalty intentions is indeed significant in this analysis ( $\beta = .13$ ,  $t = 2.15$ ). A key insight of the second model test is that customers who lose their preferred customer status perceive significantly fewer benefits from a service provider and report significantly more negative feelings toward the service provider than otherwise identical customers who have never been elevated. Again, we estimate a rival model, and the results suggest that the added relationship between demotion and loyalty intentions is insignificant ( $t = .54$ ) and, therefore, fully mediated by the proposed psychological mechanisms.

## Study 2: Investigating Demoted Customer Behavior in a Field Setting

We conducted Study 1 in a laboratory context. In Study 2, we analyze customers' behavioral reactions to status demotion using proprietary purchase data from a different industry context.

### Company Background

We gained access to proprietary sales activity data from a major retail company that operates department stores across Europe. Department store retailing has been demonstrated to be an effective context for this type of research (e.g., Lacey, Suh, and Morgan 2007). The company maintains a

hierarchical loyalty program that distinguishes between a standard customer card, which any customer can apply for and which offers minor advantages, such as flexible payment plans, and a "gold card," which assigns customers an elevated status with several additional recognition and convenience benefits (e.g., VIP events and access, preferred parking). The company automatically upgrades customers to gold status when they spend \$7,500 or more within two consecutive years; the upgrading takes place throughout the year after the required spending level has been reached.<sup>4</sup> In 2006, approximately 1.5% of the company's customer cards were gold cards. The company systematically demotes gold card owners when they no longer meet the required revenues, sending a letter that states that because the customer's revenues did not meet the revenue required for gold status over the past two years, he or she has been demoted and that the gold card is no longer valid, a procedure similar to our experimental manipulations. The demotion act is conducted annually by the end of February.

### Study Population

We obtained two sets of purchase data from the company. The first data set includes all transactions between January 2004 and July 2007 from the 1423 customers whose status was reduced in 2006 (individual-level data before 2004 are deleted by the company and therefore were not available). Note that our key variable for this analysis is purchase behavior of relationship customers over a limited period, which is conceptually different from loyalty intentions, which tend to have a "stronger theoretical meaning" (Kumar and Reinartz 2006, p. 98). However, we expect

<sup>4</sup>To protect the company's identity, all numbers reported in this part of the article are multiplied by a constant factor.

similar results for both constructs. To include data for four years (two years before demotion and two years after demotion), we consider transactions that took place only until July of the respective year. A time frame of four years of such proprietary company data of customers' purchase behaviors parallels similar research efforts (e.g., Wangenheim and Bayon 2007). Because of the strong seasonal variation in retail revenues, comparing revenues (or transactions) between different months or periods does not seem appropriate. Overall, this data set contains approximately 150,000 individual transactions, corresponding to revenues of approximately \$4.4 million. All data are adjusted for inflation. The second data set contains all transactions from the 1810 customers whose status was upgraded to gold during 2006, which enables us to compare the revenues after the demotion with customers' reaction to a status increase. With regard to the status increase effect on purchase behavior, we compare a period of equal length before the status increase with purchase patterns a year after the status increase.

### Results

Regarding the customers' reactions to status demotion, Figure 2 depicts the mean scores of the demoted customers' amount spent and number of transactions in our data set for the two years before the demotion (i.e.,  $t - 2$  and  $t - 1$ ) and the following two years (i.e.,  $t + 1$  and  $t + 2$ ). Both revenues and transactions clearly decrease after the demotion (compared with the same period in the year before the demotion), with revenues being 17.9% lower and transactions being 21.5% lower. We run t-tests to test the significance of this decrease; both changes are highly significant (revenues:  $p < .001$ ,  $t(2844) = 7.261$ ; transactions:  $p < .001$ ,  $t(2814) = 7.94$ ). We also test the change in revenues and transactions between  $t - 2$  and  $t - 1$  (the periods preceding demotion)

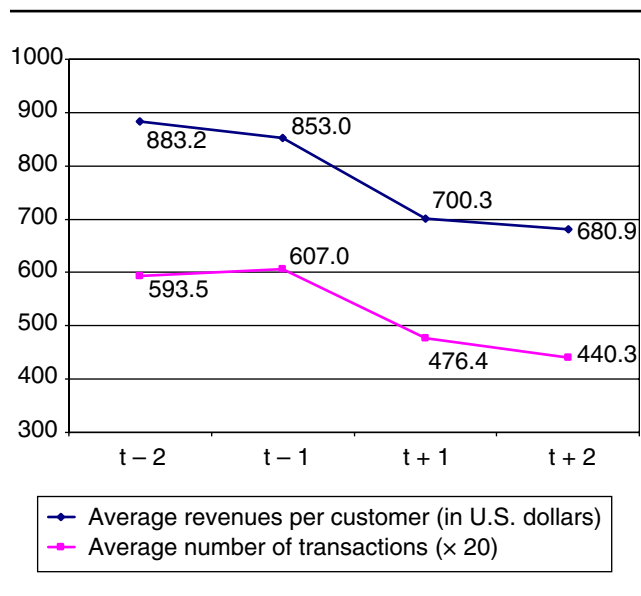
and between  $t + 1$  and  $t + 2$  (the periods following demotion). Predemotion differences are nonsignificant (revenues:  $t(2763) = 1.337$ ; transactions:  $t(2844) = -.078$ ). The difference in revenues between the two postdemotion states is also nonsignificant ( $t(2824) = .86$ ), but the decline in transactions is significant, though smaller than immediately after demotion ( $p < .05$ ,  $t(2844) = 2.31$ ). These results strongly suggest that the decline in revenues and transactions observed after the demotion is mainly caused by the demotion act itself rather than by any kind of trend. This is also supported by t-tests of the differences in revenues and transactions following the demotion and the predemotion and postdemotion differences, which show that the effects immediately following demotion are significantly stronger than those before and after the demotion act (predemotion versus demotion: revenues:  $p < .001$ ,  $t(2785) = 4.549$ ; transactions:  $p < .001$ ,  $t(2826) = 8.46$ ; postdemotion versus demotion: revenues:  $p < .001$ ,  $t(2842) = 5.427$ ; transactions:  $p < .001$ ,  $t(2774) = 6.22$ ).

To test for potential effects of relationship and consumer variables that may provide an alternative explanation of the decline in revenues and transactions, we run regressions with the change in revenues and transactions, respectively, as dependent variable and the following variables as regressors: length of gold status (in years), relationship length (in years), and gender and age as customer characteristics. For change in revenues, the regression function explains only .3% of the dependent variable and is nonsignificant ( $F = 1.20$ ). The change in transactions regression explains only marginally more variance ( $R^2 = .05$ ) and is also nonsignificant ( $F = 1.62$ ). We conclude that neither alternative relationship variables nor customer characteristics explain the decline in revenues and transactions that emerge in the data after consumers are degraded, which supports the external validity of the laboratory experimental findings of Study 1.

Because  $H_1$  suggests an asymmetric effect of status demotion compared with a status upgrade, we also analyze customers' reactions to a status upgrade, using the data from customers upgraded in 2006. We find that revenues do not increase at all as a reaction to the gold card status. Customers spent \$2,432.8 on average in the five-month period before the status upgrade and \$1,735.5 in the same period a year later. The same pattern can be found for the number of transactions; whereas the customers in our sample purchased 45.9 times in the preupgrade period, they purchased only 39.5 times after being upgraded. These results do not reflect the expected positive effect of the status increase on customers but show that customers actually buy less, despite their status being upgraded.

We believe that this finding is specific to our outcome variables of revenues and transactions and would not exist for customer loyalty intentions. Likewise, recent research has suggested that the actual spending levels of "heavy users" of a service provider, such as the elevated customers in this field study, are not positively influenced by tiered rewards provided by loyalty programs (Liu 2007). The current findings suggest that the high revenues that led to the status increase reflect exceptional one-time constellations for a substantial number of customers, who have difficulty

**FIGURE 2**  
Study 2: Revenue and Transactions of Demoted Customers





maintaining such spending levels. However, note that our results cannot rule out that customers would have shopped less in the postupgrade period with the company even if their status had not been increased, because customer lifetime value models usually assume a retention rate of less than 1, which implies a continuous downward slope of revenues over time for a given cohort of customers (Kumar and Reinartz 2006); the status increase might have diminished the function's slope. A comparison of the postupgrade and predemotion revenues and transactions, even though they result from two samples and may be biased by seasonal effects, supports the existence of this downward slope, the decline of which is substantially strengthened by customer demotion.

In summary, our initial experiment supports our proposition that demotion has the potential to drive loyal customers away from a company through different psychological mechanisms. Our analyses of company sales data show that the negative effect of demotion can also affect actual spending behavior. This raises the question whether firms can mitigate (or even completely compensate for) the potentially harmful consequences of customer demotion when they design their hierarchical loyalty programs. Next, we propose and test the effectiveness of measures that companies can deploy to reduce such negative effects.

### Alleviating the Pain: Can Loyalty Program Design Variables Reduce the Negative Consequences of Customer Demotion?

Customers tend to search for information that helps them comprehend the underlying causes that trigger negative

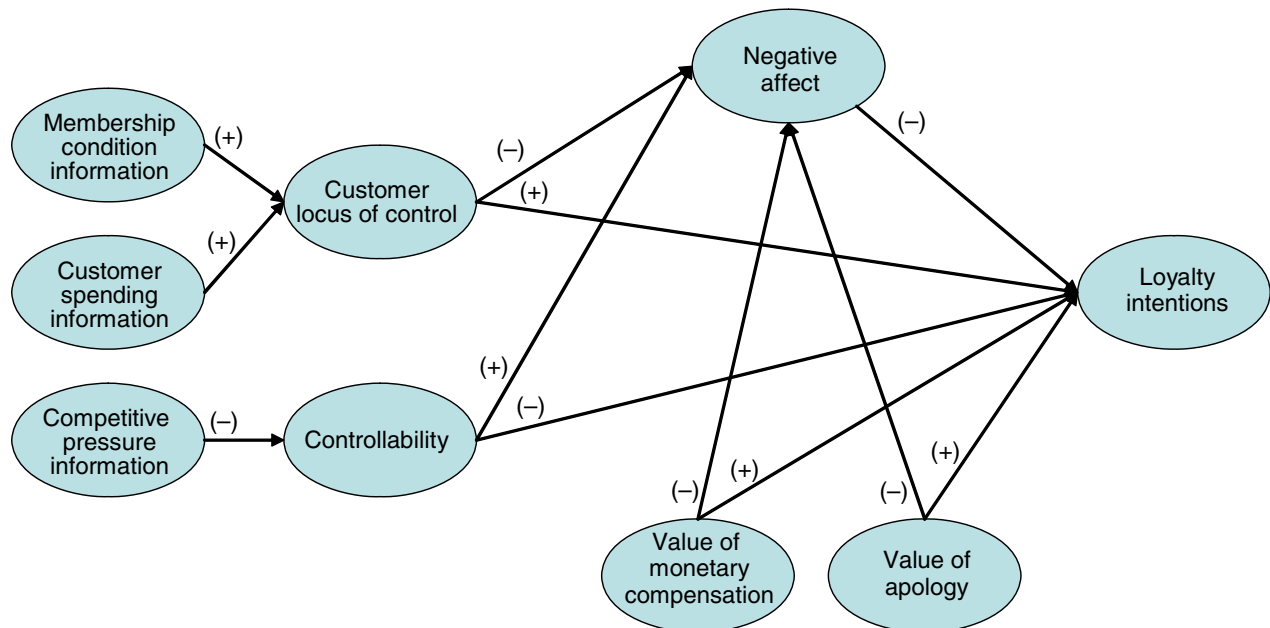
events (Kelley and Michela 1980). This impulse offers companies an opportunity to modify customers' causal attributions by manipulating the information available to them (Folkes 1987). Causal attributions refer to people's perceptions about who or what is responsible for certain events, and they serve as important determinants of consumers' respective affective and behavioral responses (Poon, Hui, and Au 2004). Attribution theory explains causal attribution, proposing that an event (e.g., negative service incident) prompts a sequence of (1) causal antecedents, (2) causal dimensions, (3) affect, and (4) behavior (Weiner 1985).

In our discussion as to which loyalty program design variables service companies can use effectively to manipulate customers' causal attributions for their demotions (for a similar approach, see Bitner 1990), we concentrate on two causal dimensions—namely, locus of control and controllability—and introduce the design variables of membership condition information, customer spending information, and competitive pressure information, all of which the fictitious company in Study 1 did not use. We refrain from manipulating the causal dimension of status stability, because the customer status awarded by hierarchical loyalty programs varies with customers' spending behavior and thus is unstable by definition. In addition, we propose two forms of company compensation that can reduce customers' negative affect and decrease in loyalty intentions: monetary and emotional compensation (i.e., offering an apology). We expect that some design variables influence loyalty intentions through affect, and therefore we include the latter construct in our model (see Figure 3).

#### Locus of Control Effects

When consumers believe that they can influence a certain outcome (i.e., have an internal locus of control), the inten-

**FIGURE 3**  
Structural Model of Marketing Activities, Causal Dimensions, and Loyalty Intentions



sity of their feelings toward a third party that is also related to the outcome tends to be weaker (Hui and Toffoli 2002). Such an internal locus of control occurs when a consumer expects a specific outcome because he or she has the information needed to build that expectation, making him- or herself responsible for the outcome (Zuckerman 1979). Specifically, information about “causal rules” influences people’s causal attributions (Weiner 1985, p. 565). Transferring this rationale into the context of customer demotion, we argue that formal membership conditions, such as a certain spending level (e.g., flight miles per year) required to maintain an elevated status, function as the causal rules of hierarchical loyalty programs, so timely provision of information about such membership conditions by the service firm should facilitate an internal locus of control. This shift of locus should then reduce the negative affect that results from a status demotion and eventually lead to a lower drop in loyalty intentions:

H<sub>3</sub>: When a customer’s status is demoted, the provision of information about elevated-status membership conditions decreases the customer’s negative affect and increases loyalty intentions through perceptions of an internal locus of control.

People’s attributions of locus of control also stem from their knowledge of their own behavior (Hansen and Donoghue 1977). For example, people who are aware that they have failed to follow instructions for product usage perceive an internal locus of causality for related product failures (Folkes 1984b). With regard to demotion, a customer’s causal attributions related to the locus of control should depend on information about his or her decline in spending with the company as the reason for the demotion. Specifically, such information by the service firm suggests that the customer holds personal responsibility for the demotion of his or her status and thus should reduce the stimulation of negative affect and limit the resulting decrease of loyalty intentions:

H<sub>4</sub>: When a customer’s status is demoted, the provision of information about the customer’s decline in spending with the firm decreases the customer’s negative affect and increases loyalty intentions through perceptions of an internal locus of control.

### **Controllability Effects**

Judgments about the controllability of an event become less pronounced when people acknowledge the situational constraints of the actor that causes the event (Gilbert, Pelham, and Krull 1988). In other words, external explanations of a negative event reduce people’s perceptions of controllability (Folkes 1984b). In particular, information about a company’s competitive situation can influence customers’ perceptions of the controllability of an event (Hunt, Kernan, and Mizerski 1983). Accordingly, we suggest that information about competitive pressure experienced by a company might create a notion of increased uncontrollability, which should decrease customers’ negative affect, leading to higher loyalty intentions toward the focal firm (e.g., Folkes, Koletsky, and Graham 1987):

H<sub>5</sub>: When a customer’s status is demoted, the provision of information about competitive pressures on the firm decreases the customer’s negative affect and increases loyalty intentions through perceptions of uncontrollability.

### **Compensation Effects**

Companies can also use design variables to reduce the negative consequences of customer demotion more directly. Specifically, prior applications of attribution theory in the context of negative consumption experiences indicate that consumers desire financial compensation and apologies from the offending firm (Folkes 1984a). Financial compensation represents monetary value for the recipient, and apologies increase liking and forgiveness (Darby and Schlenker 1982). We expect that monetary compensations and apologies offered by a firm reduce negative affect and increase the loyalty intentions of demoted customers:

H<sub>6</sub>: When a customer’s status is demoted, monetary compensation offered to the customer by the firm decreases negative affect and increases loyalty intentions.

H<sub>7</sub>: When a customer’s status is demoted, an apology offered to the customer by the firm decreases negative affect and increases loyalty intentions.

## **Study 3: Testing the Effects of Loyalty Program Design Variables**

### **Methodology**

*Context and dramaturgy.* We test our loyalty program design variables hypotheses with a second scenario experiment, employing the same industry context (i.e., airlines) as in Study 1. The design is a 2 (membership information versus no information) × 2 (customer spending information versus no information) × 2 (competitive pressure information versus no information) × 2 (monetary compensation versus no monetary compensation) × 2 (apology versus no apology) full-factorial between-groups design with 32 experimental groups. We report the full manipulations, which extend the background, elevation, and demotion information used in Study 1, in Appendix C. After presenting the manipulations, we asked participants to indicate their attributional reactions (i.e., locus of causality, controllability), level of negative affect, and loyalty intentions toward Premier Air on a set of rating scales. We also included a stable-status group and an elevated-status control group.

*Measures.* We use the same scales for negative affect and loyalty intentions as in the first study. Our scales for locus of causality and controllability come from Oliver (1997) and McAuley, Duncan, and Russell (1992), respectively, and are slightly modified to fit the context of this research (i.e., airline frequent-flier programs). Because consumers maintain different normative expectations about compensation (Bolton and Lemon 1999), we measure the perceived value of the monetary and emotional compensations in our empirical investigation by adapting Yi and Jeon’s (2003) scale and thus detect the general effect of our compensation manipulations rather than the idiosyncratic



effects of a specific fee or apology. We list all the measures used in this study in Appendix B.

*Sample.* We apply the same sampling procedure as in Study 1 for the full-factorial design but use a different set of students. Again, participants need to be current members of actual frequent-flier programs. Overall, 487 participants completed this experiment and were considered usable for data analysis (319 corresponding to the factorial design and 168 to the control groups). Participants were an average age of 43 years, 49% were women, and 49% had attended at least some college.

### Manipulation and Realism Checks

We asked respondents whether they believed that they had received information regarding membership conditions, customer spending, and competitive pressure on a scale from 1 (“absolutely false”) to 7 (“absolutely true”). For example, we measure respondents’ perceptions of membership condition information with the statement “When I was first awarded Elite Member status, I was informed by Premier Air about the formal requirements to maintain that status.” The ANOVA results show that all mean differences are statistically significant and in the expected direction (F-values range from 7.70 to 90.60, all  $p$ s < .01). We also test for confounding effects. The only potentially confounding relationship is a significant effect of membership condition information on customer spending information ( $F(1, 287) = 10.94, p < .001$ ). However, this unintended manipulation corresponds to an effect size of a partial  $\eta^2 = .03$ , which is much smaller than the effect size of the desired effect (partial  $\eta^2 = .24$ ) and, according to Perdue and Summers (1986, p. 323), should “not be of great concern.” We again asked respondents to judge the realism of our experimental scenarios, using the same items as in Study 1. As in our first experiment, the results suggest that participants perceived the experimental design as realistic ( $M_{\text{composite score}} = 5.86, SD = 1.45$ ).

### Validity Assessment

We again assess the measurement properties of all dependent variables with a confirmatory factor analysis (LISREL 8.71), which indicates a good overall fit of the model ( $\chi^2(67) = 109.83, p < .001$ ; root mean square error of approximation = .04; nonnormed fit index = .99; compara-

tive fit index = .99) and solid psychometric properties of our scales. Specifically, all standardized factors loadings have a positive sign and substantial magnitude, ranging between .76 and .97. Each loading is significant at  $p < .001$ , in support of convergent validity. The composite reliabilities demonstrate values between .89 and .95, alphas range from .90 to .95, and AVEs vary from .68 to .82. All construct pairs achieve discriminant validity (Fornell and Larcker 1981). Descriptive statistics and correlations for this study appear in Table 3.

### Results

We first compare the combined sample of respondents who experienced a status demotion with the stable-status and elevated-status control groups. The results are consistent with Study 1, and ANOVAs provide additional evidence that customer demotion can harm healthy relationships with customers. Specifically, loyalty intentions scores are significantly lower for demoted customers ( $M_{\text{DS}} = 4.50$ ) than for both stable-status ( $M_{\text{SS}} = 5.92; F(1, 384) = 37.88, p < .001$ ) and elevated-status ( $M_{\text{ES}} = 6.25; F(1, 418) = 88.02, p < .001$ ) customers.

When we compare the loyalty intentions means of demoted customers exposed to one of the five manipulations with those of elevated-status and stable-status customers, we find that loyalty intentions are higher for four of the five manipulations compared with demoted customers with no positive manipulation, which suggests that loyalty program design variables can indeed mitigate the negative effects of customer demotion to a certain extent (see Table 4). However, customers who were neither demoted nor elevated exhibited higher loyalty intentions than those who were exposed to one or even all relevant loyalty program design variables, so the power of these actions appears limited in its effect.

Next, to test the relationships proposed in  $H_3$ – $H_7$ , we use the demotion scenarios and apply PLS. The results appear in Table 5. Regarding the links between loyalty program design variables and causal dimensions, our findings suggest that membership condition information ( $\gamma = .19, t = 3.53$ ) and customer spending information ( $\gamma = .20, t = 3.94$ ) increase perceptions of an internal locus of control, as  $H_3$  and  $H_4$  propose. Consistent with  $H_3$  and  $H_4$ , an internal locus of control reduces negative affect ( $\beta = -.34, t = -6.28$ )

**TABLE 3**  
**Study 3: Correlation Matrix (n = 319)**

	M (SD)	CI	MI	CP	CLO	AFF	CO	LOY	EC	AP
Customer spending information (CI)	N.A.	1								
Membership condition information (MI)	N.A.	-.01	1							
Competitive pressure information (CP)	N.A.	-.04	.08	1						
Customer locus of control (CLO)	4.19 (2.22)	.19**	.19**	-.15**	1					
Negative affect (AFF)	4.09 (1.78)	-.05	-.12*	-.02	-.35**	1				
Controllability (CO)	5.40 (1.91)	.00	-.04	-.22**	.11*	.07	1			
Loyalty intentions (LOY)	5.06 (1.79)	.07	.04	-.09	.39**	-.39**	.06	1		
Value of monetary compensation (EC)	2.32 (1.80)	.00	-.08	-.05	.00	.00	.11*	.06	1	
Value of apology (AP)	3.33 (2.06)	.04	.01	.14	.06	-.14*	.18**	.20**	.34**	1

\* $p < .05$  (two-tailed).

\*\* $p < .01$  (two-tailed).

Notes: N.A. = not applicable.

**TABLE 4**  
**Study 3: Overview of Loyalty Intention Means**

Company Measures	M	n	Elevated-Status Control Group (n = 101, M = 6.26)		Stable-Status Control Group (n = 67, M = 5.93)	
			F	p <	F	p <
Membership condition information	4.59	167	(1, 266) = 72.87	.001	(1, 232) = 30.25	.001
Customer spending information	4.63	157	(1, 256) = 61.36	.001	(1, 222) = 25.17	.001
Competitive pressure information	4.33	146	(1, 245) = 92.75	.001	(1, 211) = 40.92	.001
Monetary compensation	4.54	173	(1, 272) = 76.59	.001	(1, 238) = 32.31	.001
Apology	4.57	168	(1, 267) = 71.07	.001	(1, 233) = 29.71	.001
All measures <sup>a</sup>	4.77	11	N.A. <sup>c</sup>	N.A.	N.A.	N.A.
No measures <sup>b</sup>	4.44	13	N.A.	N.A.	N.A.	N.A.

<sup>a</sup>"All measures" denotes that participants were exposed to all five manipulated conditions, including information pertaining to membership conditions, customer spending, competitive pressure, monetary compensation, and apology.

<sup>b</sup>"No measures" denotes that participants were not exposed to any of the five manipulated conditions.

<sup>c</sup>N.A. = significance tests are not applicable because of a limited number of cases in group.

**TABLE 5**  
**Study 3: Path Coefficients from PLS Analysis**

Effects on Causal Dimensions					
Structural Path	Estimate	t-Value	Total Impact	R <sup>2</sup>	
Membership condition information → customer locus	.19**	3.53	.19	.08	
Customer spending information → customer locus	.20**	3.94	.20		
Competitive pressure information → controllability	-.23**	-4.43	-.23	.05	
Effects on Negative Affect					
Customer locus → negative affect	-.34**	-6.28	-.34	.14	
Controllability → negative affect	.01	.21	.01		
Value of monetary compensation → negative affect	.06	1.04	.06		
Value of apology → negative affect	-.14*	-2.38	-.14		
Effects on Loyalty Intentions					
Customer locus → loyalty intentions	.27**	4.96	.37	.25	
Controllability → loyalty intentions	-.02	-.33	-.01		
Value of monetary compensation → loyalty Intentions	.01	.21	.00		
Value of apology → loyalty intentions	.15*	2.49	.19		
Negative affect → loyalty intentions	-.28**	-4.93	-.28		

\*p < .05 (two-tailed).

\*\*p < .01 (two-tailed).

and increases loyalty intentions ( $\beta = .27, t = 4.96$ ). Accordingly, we find full support for H<sub>3</sub> and H<sub>4</sub>. However, while competitive pressure information indeed negatively affects the notion of controllability ( $\gamma = -.23, t = -4.43$ ), as H<sub>5</sub> proposes, the relationships between controllability and both negative affect and loyalty intentions are insignificant, meaning that information about competitive pressure does not reach these outcome variables, which is in conflict with H<sub>5</sub>. The rationale for this lack of impact of controllability may be that the formal requirements and assured benefits of loyalty programs are perceived as contractual in nature by consumers (Rowley 2007), thus potentially eliciting little sympathy for firms struggling with their self-imposed rules. The value of the monetary compensation has no impact on either outcome variable, which does not support H<sub>6</sub>. However, the value of an apology reduces the customer's negative affect ( $\gamma = -.14, t = -2.38$ ) and directly increases his or her loyalty intentions toward the firm ( $\gamma = .15, t = 2.49$ ), in

full support of H<sub>7</sub>. The difference in impact of apologies and monetary compensations is in line with research that suggests that social benefits, such as personal communication by service firm representatives, affect customers' commitment to and, thus, loyalty toward firms to a greater extent than economic incentives (Hennig-Thurau, Gwinner, and Gremler 2002). Finally, negative affect again reduces customer loyalty intentions ( $\beta = -.28, t = -4.93$ ).

In summary, the results of Study 3 suggest that customers' perceptions of locus of control and controllability can be manipulated by deploying relevant loyalty program design variables. However, the impact of these two causal dimensions on customers' experiences of negative affect and loyalty intentions differs. Whereas a perceived internal locus of control increases loyalty intentions both directly and indirectly by reducing the negative affect caused by demotion incidents, controllability does not influence any of the outcome variables significantly. The two compensa-

tion measures included in our study also differ in their potential to reduce negative affect and increase loyalty intentions. While the value of a monetary compensation does not appear to exert any impact on these outcome variables, the value of an apology reduces demoted customers' negative affect and increases their loyalty intentions, both directly and indirectly through affect. At the same time, even when we find significant relationships, the absolute size of the effects appears limited, meaning that the loyalty program design variables can only partially compensate for the overall negative impact caused by customer demotion.

## Managerial Implications: Deciding When and How to Demote

Whereas hierarchical loyalty programs have been implemented in several service industries for many years, marketing academics have just recently begun acknowledging differentiations in customer status as a crucial relationship management variable (e.g., Wangenheim and Bayon 2007). The initial findings suggest that elevated-status customers tend to demonstrate certain desired characteristics, such as more pronounced intentions of future purchases (Dreze and Nunes 2007; Lacey, Suh, and Morgan 2007) and superior satisfaction with the firm, compared with standard customers (Homburg, Droll, and Totzek 2008). What has remained unexplained, however, is the dark side of such status differences—namely, the demotion inherent with the concept of status differences commonly imposed by service firms on thousands of customers every day. As a first step toward closing this gap, studying customers' psychological and behavioral responses to relationship status reductions appears to be highly relevant for marketing researchers and practitioners alike.

Using two experimental investigations and a field study of proprietary company data, we apply ANOVA and PLS and find that status demotion exerts an overall asymmetric negative effect on customer loyalty intentions, such that the negative impact of status decreases is stronger than the positive influence of status increases. We test how service firms can mitigate the harmful consequences of customer demotion when they design their loyalty programs and find that firms can indeed manipulate customers' causal attributions, but only a perceived internal locus of control and personal apologies offered to demoted customers reduce decreases in loyalty intentions to a certain extent.

To derive better assessments of whether hierarchical loyalty programs are economically reasonable and how they should be structured, firms must analyze how status increases and decreases affect their success. We address this issue, proposing an analytical model with the purpose to aid respective managerial decision making (Thompson, Hamilton, and Rust 2005).

### **The Effects of Customer Demotion on Customer Equity**

The analytical model links customer demotion to customer equity, a key element of firm value from a strategic perspective (e.g., Rust, Lemon, and Zeithaml 2004). For that pur-

pose, we compare the effects of a bidirectional hierarchical customer loyalty program (BHLP), in which customers are both upgraded and demoted, on customer equity with two strategic alternatives to such a program: (1) a nonhierarchical loyalty program in which customers are neither upgraded nor demoted (NHLP) and (2) a unidirectional hierarchical customer loyalty program (UHLP) in which customers are only upgraded but not demoted. In line with the rationale of our empirical studies, we model upgraded customers U, demoted customers D, and regular (i.e., neither upgraded nor demoted) customers R as separate groups, all being members of the company's loyalty program. Their customer lifetime value, weighted with the respective group size, determines the company's customer equity:

$$(1) \quad CE = N \times \sum_G w_g \times CLV_g, \left\{ 0 \leq w_g \leq 1; \sum_G w_g = 1 \right\},$$

where CE is the firm's customer equity, CLV<sub>g</sub> is the average customer lifetime value per member of group g, w is the size of a group, G are the groups (with U, D, R ∈ G), and N is the total number of customers the company has, which we assume to be constant over time. We define each group's customer lifetime value as follows (Berger and Nasr 1998):

$$(2) \quad CLV_g = (S_g - C_g) \times \sum_{t=1}^{\infty} \frac{r_g^t}{(1+d)^t}, \{0 \leq r \leq 1\},$$

where r is the retention rate for each group g per period t, d is the discount rate, S are the average sales per member of a group, and C are the average marketing costs per member of a group. The marketing costs result from the loyalty program and other marketing activities of the firm. The difference between S and C represents the contribution margin.<sup>5</sup> We assume that r values are equal for R and for customers of a firm that does not offer such a program. Studies 1 and 3 provide evidence that both the elevation and the demotion of customer status influence customer loyalty intentions, which can be translated into customers' retention rate r (Gupta and Zeithaml 2006). More specifically, our experimental findings suggest that r<sub>U</sub> > r<sub>R</sub> > r<sub>D</sub> and that the effect of demotion is asymmetric (i.e., r<sub>U</sub> - r<sub>R</sub> < r<sub>R</sub> - r<sub>D</sub>). Study 3 also shows that the latter condition is true regardless of the design of the upgrading and demotion process. Furthermore, we assume that the customers' sales are not affected by the existence of a hierarchical loyalty program and that, as customers are upgraded according to their sales, sales are

<sup>5</sup>Note that estimating the retention rate for customers in non-contractual settings "might be an especially daunting task" (Villanueva and Hanssens 2007, p. 9). Several different methods have been suggested in the customer lifetime value literature to accomplish this task, but it is beyond the realm of our analytical modeling to include them in our argumentation. The company in our empirical case, as well as several airlines, solves this challenge by offering a "basic" customer card, which enables the company to track the purchases of a majority of its customers even when no formal "contract" exists.

higher for U than for both D and R (i.e.,  $S_U > S_R, S_D$ ). Regarding costs, the different groups U, D, and R differ in terms of marketing costs, with the average costs per member of U being higher than those for both members of R and D (i.e.,  $C_U > C_R, C_D$ ) as a result of the additional benefits offered to upgraded customers. In addition, average marketing costs per member of R are equal to average marketing costs for customers who are NHLP members.

*Comparing the effects of BHL P and NHL P.* To generate higher customer equity than a nonhierarchical program, the weighted total customer lifetime value of the three groups of the BHL P must be higher than the total NHL P. Formally,

$$(3) \quad w_R \times (S_R - C_R) \times \sum_{t=1}^{\infty} \frac{r_R^t}{(1+d)^t} + w_U \times (S_U - C_U) \times \sum_{t=1}^{\infty} \frac{r_U^t}{(1+d)^t} + w_D \times (S_D - C_D) \times \sum_{t=1}^{\infty} \frac{r_D^t}{(1+d)^t} > (S_{NHL P} - C_{NHL P}) \times \sum_{t=1}^{\infty} \frac{r_{NHL P}^t}{(1+d)^t}.$$

Whether this condition is met depends on the size of three effects: (1) a positive effect on the customer equity of the BHL P that stems from the higher retention rate for upgraded customers, (2) a negative effect on the customer equity of the BHL P as a result of the lower retention rate for demoted customers, and (3) another negative effect on the customer equity of the BHL P caused by the higher marketing costs (and, consequently, the lower average contribution margin) for upgraded customers. Formally,

$$(4) \quad r_U - r_{NHL P} \rightarrow \Delta CE_1,$$

$$(5) \quad r_{NHL P} - r_D \rightarrow \Delta CE_2, \text{ and}$$

$$(6) \quad C_U - C_{NHL P} \rightarrow \Delta CE_3.$$

A first finding of our analytical model is that the BHL P generates higher customer equity than the NHL P if  $\Delta CE_1$  exceeds the sum of  $\Delta CE_2$  and  $\Delta CE_3$ . Because of the asymmetric effect of demotion shown in Studies 1 and 3, a positive total effect can exist only if the number of upgraded customers  $w_U$  (and, consequently,  $\Delta CE_1$ ) is higher than the number of demoted customers  $w_D$  (and, consequently,  $\Delta CE_2$ ), which constitutes a second finding. The relative group sizes can be actively influenced by the company through manipulating the conditions under which customers are elevated and under which they are demoted, such as the minimum spending level required for a higher status (i.e., higher spending levels reduce the number of upgraded customers) and the length of status upgrade intervals (i.e., longer intervals reduce the number of demoted customers). In addition, the incremental marketing costs for the upgraded customer group must be considered. Even if  $w_U$  is greater than  $w_D$ , a positive total effect of the BHL P requires the retention rate-based increase in customer equity (i.e.,  $\Delta CE_1 - \Delta CE_2$ ) for upgraded customers to be greater than the cost-based decrease in customer equity (i.e.,  $\Delta CE_3$ ), which represents our third finding. Because Study 1 demonstrates that perceived benefits fully mediate the effect of sta-

tus upgrades on retention, lowering the marketing costs for U is not an easy solution, because it will not only reduce  $\Delta CE_3$  but also alleviate  $\Delta CE_1$ .

*Comparing the effects of BHL P and UHLP.* Would it be a solution only to upgrade but not to demote customers (i.e., using the positive effects of upgrading and avoiding the negative effects of demotion)? To address this question, we compare the standard BHL P with the UHLP. The latter program would contain one additional group of customers, U\*—customers who have been upgraded but who no longer meet the upgrading requirements but are still treated preferentially. It is important to consider this group, because the average sales per member  $S_{U^*}$  are equal to those of the demoted customer group  $S_D$  of the BHL P but lower than the average sales per member of the “regular” upgraded customers  $S_U$ . In this case, the UHLP would need to meet the following condition:

$$(7) \quad w_R \times (S_R - C_R) \times \sum_{t=1}^{\infty} \frac{r_R^t}{(1+d)^t} + w_U \times (S_U - C_U) \times \sum_{t=1}^{\infty} \frac{r_U^t}{(1+d)^t} + w_{UN} \times (S_{U^*} - C_{U^*}) \times \sum_{t=1}^{\infty} \frac{r_{U^*}^t}{(1+d)^t} > w_R \times (S_R - C_R) \times \sum_{t=1}^{\infty} \frac{r_R^t}{(1+d)^t} + w_U \times (S_U - C_U) \times \sum_{t=1}^{\infty} \frac{r_U^t}{(1+d)^t} + w_D \times (S_D - C_D) \times \sum_{t=1}^{\infty} \frac{r_D^t}{(1+d)^t},$$

where the term before the greater than sign is the customer equity of the UHLP and the term after the sign is the customer equity of the BHL P. The U\* group has a lower contribution margin than demoted customers as a result of the higher marketing costs for upgraded customers, but this group exhibits a higher retention rate. Formally,

$$(8) \quad r_{U^*} - r_D \rightarrow \Delta CE_4, \text{ and}$$

$$(9) \quad C_{U^*} - C_D \rightarrow \Delta CE_5.$$

If we assume that all other parameters are equal, the UHLP is superior to the BHL P if the retention rate-based effect on customer equity is greater than the cost-based effect (i.e.,  $\Delta CE_4 > \Delta CE_5$ ); this is our fourth finding. Finally, note that even if this condition is met, the UHLP must also generate higher customer equity than the NHL P to make sense economically. If the condition given in Equation 3 is not met by the BHL P, the difference in customer equity between the UHLP and the BDHL (see Equation 7) must exceed the difference in customer equity between the NHL P and the BDHL (see Equation 3), which represents our fifth finding.

## **Handling the Demotion Process**

Although firm-specific applications of the discussed analytical principles may suggest that the elevation and demotion of customer status is not economically reasonable, it must be acknowledged that in many service industries, the awarding of such preferred status to high-spending customers frequently occurs simply for reasons of competitive parity, and it is unrealistic to expect that customer status demotions can be largely avoided in general. However, many service firms award elevated customer status in one-year periods, such that initially elevated customers frequently lose their status after one year. Because making reliable assessments about customers' contributions to firms' profits based on such brief periods tends to be problematic (Venkatesan, Kumar, and Bohling 2007), it is possible that the loyalty of far too many potentially valuable customers is jeopardized by demoting them prematurely. In addition, people may feel that they were not given a fair chance to prove themselves as valuable customers within such a limited time frame, which may lead to perceptions of unfairness, another critical psychological mechanism in customer-company relationships. Given the substantially negative consequences following incidents of status demotions, we suggest that firms implement longer periods of status elevation. We speculate that minimizing the risk of driving away valuable customers outweighs the additional marketing costs of extending elevated status for another year or two.

Companies should aggressively attempt to maximize the salience of an internal locus of control by reminding customers proactively of both their spending decline and the formal requirements to maintain an elevated status. We find it remarkable that some companies (e.g., Lufthansa) have begun to offer customers who are about to be demoted the opportunity to purchase the revenues (e.g., flight miles) that are "missing" to maintain their elevated status. Such an offer clearly contributes to an internal locus because customers are enabled to maintain their status actively instead of simply having to accept the company's decision. In addition, our findings demonstrate that offering customers an apology (e.g., through a letter) is a much more efficient marketing tool in a degradation context than providing monetary compensation. This finding is especially noteworthy because apologies are much cheaper for a company than offering financial forms of compensation.

## **Limitations and Further Research**

Although this study provides initial insights into the psychological and behavioral consequences of changes in service customers' relationship status, subsequent research efforts are needed to gain additional insights into this issue. Foremost, the effectiveness of varying configurations of hierarchical loyalty programs needs to be studied in more detail. For example, future work could investigate the dynamics caused by status changes among more differentiated hierarchical levels with several elevated-status designations. Likewise, other research could examine the effectiveness of varying lengths of initial status qualification periods

and compare various time frames of (minimum) elevated-status membership, as well as incorporating costs into the analysis. At a more fundamental level, it is important to investigate the extent to which loyalty programs in general and customer status differentiations indeed create "true" customer loyalty instead of providing incentives of a short-term nature to choose a certain service provider (i.e., spurious loyalty; Dick and Basu 1994). Further research could also incorporate a wider array of psychological variables into theoretical explanations of customers' reactions to status changes. For example, the potentially moderating impact of relevant personality traits on status change outcomes represents an avenue for further research. Relatedly, it would be worthwhile to account for potential additional effects of attributions in the context of relationship status changes (e.g., positive outcomes). Regarding the samples of our two experimental studies, we included only consumers who were experienced with airline loyalty programs; we did not limit our study to those whose status had been elevated by an airline in real life. Although our description of benefits exclusively offered to elevated customers is based on a content analysis of actual bonus programs, which should ensure a high level of external validity, it would be worthwhile to determine whether customers' actual experience has any influence on the results. Although our analytical procedures suggest that demand artifacts are no substantial threat to our experimental findings, it must be acknowledged that all behavioral experiments are subject to demand artifacts to some extent (Argyris 1968), thus representing a methodological limitation. Finally, although our analytical model provides important insights into the economic consequences of hierarchical loyalty programs, further research could clearly extend the model by testing its assumptions and by empirically estimating its parameters.

## **Appendix A Study 1: Background Information and Manipulations**

### ***Initial Background Information (Stable-, Elevated-, and Demoted-Status Groups)***

Premier Air is one of the largest airline companies in the world, connecting all major airports around the globe.

As a frequent customer of Premier Air, you have been enrolled in the company's frequent-flier program ever since you started flying with them 5 years ago. The frequent-flier program allows you to accumulate flight miles and to redeem those miles on future flights.

You have been flying frequently with Premier Air and enjoyed it.

### ***Status Elevation Manipulation (Elevated- and Demoted-Status Groups)***

Two years ago, the company elevated you to Elite Member status because you have been such a loyal customer. As an Elite Member you get preferred customer treatment. The benefits of being an Elite Member include:

- You are often bumped up to fly Business Class or even First Class for free;
- You are allowed to use the company's exclusive *Elite Member* airport lounges, which allow you to relax in a pleasant setting and to enjoy a selection of complementary beverages, snacks, and newspapers;
- You are guaranteed a seat on board when requesting it up to 48 hours before departure;
- You are invited to enter the airplane before the standard customer; and
- You have access to a special telephone hotline for preferred customers where you can make reservations and get your

questions answered by specially qualified and courteous service personnel.

### **Status Demotion Manipulation (Demoted-Status Group Only)**

Over the last 12 months, you have continued to travel frequently with Premier Air, but not quite as much as in previous years.

Today you receive a letter by Premier Air's customer service department. It tells you that your customer status has been reduced. From today on, you are no longer an Elite Member.

## **APPENDIX B**

### **Studies 1 and 3: Measures**

Construct	Items	CR/AVE <sup>a</sup>	Based on
Convenience benefits (Study 1)	<p><i>What benefits do you gain from being a customer of this airline?<sup>b</sup></i></p> <ul style="list-style-type: none"> <li>•Being a customer of this airline makes my traveling more convenient.</li> <li>•Being a customer of this airline makes me save time and effort.</li> <li>•Being a customer of this airline allows me to travel with lesser effort.</li> </ul>	.97/.87 <sup>f</sup>	Morganosky 1986; Paul et al. 2009
Recognition benefits (Study 1)	<ul style="list-style-type: none"> <li>•Being a customer of this airline makes my traveling easier.</li> <li>•Being a customer of this company makes me feel privileged compared to others.</li> <li>•Being a customer of this company makes me feel special compared to others.</li> <li>•Because I am a customer of this company others look up to me.</li> <li>•Being a customer of this company makes me demonstrate greater success than others.</li> </ul>	.90/.69 <sup>f</sup>	Netemeyer, Burton, and Lichtenstein 1995; Paul et al. 2009
Customer locus of control (Study 3)	<p><i>The status reduction ...<sup>c</sup></i></p> <ul style="list-style-type: none"> <li>•Occurred because of something I did/occurred because of something the airline did. (R)</li> <li>•Was caused by me/was caused by the airline. (R)</li> <li>•Is due to my behavior/is due to the airline's behavior. (R)</li> </ul>	.93/.81 <sup>g</sup>	Oliver 1997
Controllability (Study 3)	<ul style="list-style-type: none"> <li>•Was not controllable by the airline/was controllable by the airline.</li> <li>•Is something the airline had no power over/is something the airline had power over.</li> <li>•Could not have been regulated by the airline/could have been regulated by the airline.</li> </ul>	.93/.82 <sup>g</sup>	McAuley, Duncan, and Russell 1992
Value of compensation (Study 3)	<p><i>Did you receive any compensation of value to you by the airline?<sup>d</sup></i></p> <ul style="list-style-type: none"> <li>•I received an economic compensation by the airline which has a high cash value for me.</li> <li>•I received an apology by the airline which has a high emotional value for me.</li> </ul>	N.A.	Yi and Jeon 2003
Negative affect (Studies 1 and 3)	<p><i>How does this situation make you feel?<sup>b</sup></i></p> <ul style="list-style-type: none"> <li>•Angry</li> <li>•Frustrated</li> <li>•Irritated</li> <li>•Annoyed</li> </ul>	.97/.88 <sup>f</sup> .89/.68 <sup>g</sup>	Larsen and Diener 1992; Richins 1997



**APPENDIX B**  
**Continued**

Construct	Items	CR/AVE <sup>a</sup>	Based on
Loyalty intentions (Studies 1 and 3)	<i>How would you behave based on this experience?</i> <sup>e</sup> <ul style="list-style-type: none"> <li>•I would continue flying with this airline.</li> <li>•The next time I need to air travel, I would fly with this airline.</li> <li>•I would consider this airline my first choice to air travel.</li> <li>•I would use the services of this airline in the next years.</li> </ul>	.97/.89 <sup>f</sup> .95/.82 <sup>g</sup>	Agustin and Singh 2005; Johnson, Herrmann, and Huber 2006; Zeithaml, Berry, and Parasuraman 1996

<sup>a</sup>CR = construct reliability, and AVE = average variance extracted.

<sup>b</sup>We obtained responses using seven-point scales, anchored by “disagree completely” (1) and “agree completely” (7).

<sup>c</sup>We obtained responses using seven-point bipolar scales, anchored by the statement mentioned first (1) and the statement mentioned second (7).

<sup>d</sup>We obtained responses using seven-point scales, anchored by “absolutely false” (1) and “absolutely true” (7).

<sup>e</sup>We obtained responses using seven-point scales, anchored by “very unlikely” (1) and “very likely” (7).

<sup>f</sup>We obtained measurement properties from Study 1.

<sup>g</sup>We obtained measurement properties from Study 3.

Notes: N.A. = not applicable, and (R) = reverse scored.

## Appendix C

### Study 3: Manipulations

#### **Membership Condition Information (Presented Following the Status Elevation Information)**

Along with the information on your Elite Member status, you were informed that in order to maintain this preferred customer status, you are required to fly at least 25,000 miles every year with Premier Air.

#### **Customer Spending Information (Presented Following the Status Degradation Information)**

The reason given in the letter is that you flew less than 25,000 miles within the last 12 months and, hence, do not meet the requirements for being an Elite Member.

#### **Competitive Pressure Information (Presented Following the Status Degradation Information)**

The letter informs you that Premier Air is currently facing dramatic competitive pressure. To avoid bankruptcy, the

company is forced to reduce costs and can afford to have only a limited number of Elite Members.

#### **Apology (Presented Following the Status Degradation Information)**

Dave Smith, CEO of Premier Air, has added and personally signed the following postscript: “I wish to personally apologize for this inconvenience. We appreciate having you as a customer and look very much forward to serving you in the future.”

#### **Monetary Compensation (Presented Following the Status Degradation Information)**

Enclosed with the letter, you find a \$30 gift certificate for future Premier Air flights issued to your name as a compensation for potential inconveniences.

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