Special Session Summary  Simple Payments and Complex Rewards: Consumers’ Preference For Complexity in Payment Versus Reward Schedules

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SESSION OVERVIEW

Marketers can choose from many ways in which to frame the costs and benefits that follow from consumption. The services industry in particular has recently seen a proliferation of both payment and reward plans. These plans can differ widely in terms of their complexity. Payment schedules range from simple flat rates to per-unit fees and 2 part tariffs, whereas rewards programs range from single-medium plans to multi-medium plans and from simple fungible plans to complex plans in which only specific levels of points can be exchanged for rewards. The three papers reported here examine the effects of varying types of complexity for both payment and reward plans. Together, they indicate that consumers have a strong preference for simplicity in payment plans, but sometimes prefer complexity to simplicity when it comes to reward schedules.

The paper by Meyvis and Xie compares consumers’ preference for simple flat rates versus more complex per-unit pricing. Whereas previous research has documented a preference in favor of the simple flat rates, these studies show that this preference is magnified in a dynamic setting: consumers are less likely to switch from a flat rate to an equivalent linear rate than they are to switch from a linear rate to an equivalent flat rate. The added dynamic advantage for flat rates seems to be due to asymmetries in loss aversion, not to asymmetries in the adjustment of usage estimates. Whereas the first paper examines different ways to formulate the cost incurred with consumption, the remaining two papers focus on ways to formulate the benefits/rewards accrued with consumption.

While simplicity is preferred on the cost-side, it is not always optimal for formulating rewards. The paper by Soman, Shi, and Li demonstrates that adding additional intermediate stages (e.g., points to be exchanged for vouchers) to reward plans can increase consumers’ preference for these plans. Although the complexity of the plan increases, the intermediate stages may serve as subgoals that can make final rewards seem more achievable and enhance consumers’ motivation.

Finally, in the paper by Nunes and Drèze, the complexity of the reward plans is changed by varying the fungibility of the accrued points. As the number of reward levels decreases, the point become less fungible and harder to redeem. However, although a perfectly fungible points program is the least complex plan, it does not maximize consumers’ loyalty as spending becomes too easy and the rewards no longer serve as meaningful goals.

By bringing together research on both payment and reward schedules, we aim to highlight the differences as well as the similarities in consumers’ reactions to the properties of these schedules. Pricing plans and reward programs share similar characteristics and can vary along the same dimensions, one of which being the degree of complexity. Just as payment plans can be flat or usage-based, reward schedules can also vary in their degree of contingency. Just as reward schedules can incorporate different numbers of mediums, payment plans can include mediums, such as the requirement to purchase points that can later be used to acquire services.

“Switching between Flat and Linear Pricing Schedules: A Dynamic Advantage for Flat Rates”

Tom Meyvis, New York University
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Many services offer consumers the option to either pay for each unit they consume (per-unit pricing) or to simply pay one flat, fixed fee instead. Examples include cell phone calling plans, public transportation, and health clubs. Several studies have documented a flat rate bias: consumers often choose flat rates when they would have been better off by paying per unit (Kridel, Lehman, and Weisman 1993, Nunes 2000). A number of factors may contribute to this exaggerated flat rate preference, including reduced complexity, increased convenience, increased enjoyment of the service, reduced uncertainty, self-control goals, and overestimation of usage. The objective of this project is to examine whether, aside from the documented static preference for flat rates over linear rates, there may also be a dynamic preference for flat rates. More specifically, even when flat and linear rates are equally attractive, consumers may find it easier to switch from the linear rate to the flat rate than to switch from the flat rate to the linear rate.

In our first experiment, we created three different between-subjects conditions. In the control condition, subjects were indifferent between an attractive flat rate and a comparably attractive linear rate. In the switch-from-linear condition, subjects were first presented with the attractive linear rate from the control condition and an overpriced flat rate. Subjects naturally preferred the linear rate. When this flat rate was then gradually reduced to the attractive rate from the control condition, the majority of the subjects switched to the flat rate. Finally, in the switch-from-flat condition, subjects were first presented with the attractive flat rate from the control condition and an overpriced linear rate. Subjects naturally preferred the flat rate. When the linear rate was then gradually reduced to the attractive linear rate from the control condition, only a minority of subjects switched.

There are a number of mechanisms that can explain the observed disproportionate “stickiness” of flat rates. First, consumers who currently have a flat rate may forget to adjust their usage downward when considering switching to a linear rate. This would make the linear rate appear overly expensive and thus discourage the switch. In contrast, when consumers consider switching to a flat rate, the increase in usage is very salient, as the flat rate in essence implies “use as much as you want.” Second, consumers who consider switching to a linear rate may adjust their usage, but anchor on their current flat rate usage and adjust insufficiently (e.g., Mussweiler and Strack 2001), again making the linear rate appear overly expensive. Finally, consumers may sufficiently adjust their estimates of service usage, but feel worse about reducing their usage of the service (when switching to a linear rate) than they do about giving up money (when switching to a flat rate). This last explanation assumes that consumers exhibit a greater loss aversion bias for service usage than they do for money. This would be consistent with prior findings from the promotion literature that consumers are more reluctant to trade down (sacrifice quality for price) than to trade up (sacrifice price for quality) (e.g., Hardie, Johnson, and Fader 1993).
Whereas the first experiment demonstrated the disproportionate stickiness of flat versus linear rates, the subsequent experiments tried to distinguish between the three alternative accounts of the effect. The results of the second experiment demonstrated that the effect was magnified when participants were asked to explicitly estimate how much their usage of the service would change if they would switch to the new rate. This is inconsistent with the first explanation (i.e., consumers forget to adjust their usage downward when considering to switch to a flat rate), but consistent with both the second explanation (i.e., anchoring and insufficient adjustment) and the third explanation (asymmetric loss aversion for money vs. usage). In a third experiment, we observed that the effect persisted when the usage estimates for the different (randomly ordered) pricing plans were elicited before the experiment. Since this manipulation removed any systematic anchoring effects, these results ruled out the anchoring and insufficient adjustment account, but were consistent with the asymmetric loss aversion account. Finally, in the fourth experiment, we observed that the disproportionate “stickiness” of flat rates persisted even when the increase in spending when switching from a linear rate to a flat rate was made salient.

Together, these studies indicate that consumers are more likely to switch from a linear rate to an equivalent flat rate than they are from a flat rate to an equivalent linear rate. This dynamic advantage for flat rates seems to be driven by a greater loss aversion for service usage than money. Furthermore, this asymmetric loss aversion is not the result of a greater salience for reducing usage than for increasing expenses, but instead seems to result from fundamental differences in the valuation of decreasing benefits versus increasing expenses.

“Multi-Medium Reward Programs”
Dilip Soman, University of Toronto
Mengze Shi, University of Toronto
Xiuping Li, University of Toronto

Consumer reward programs offer a reward for repeatedly purchasing from the same marketer. In a typical reward program, consumers earn a number of points for every purchase they make (Neslin 2002). More recently, Hee et al. (2003) demonstrated the mediating role of the reward points, which they conceptualized as “medium,” in the relationship between an action and a final reward (outcome). They found that in choice situations where the effort and outcome were held constant, consumer choice was systematically influenced by the presence and quality of the medium, both of which should be irrelevant normatively. In another recent paper, Soman and Shi (2003) show that in goal oriented situations, the temporal path of task completion influences the perceived progress towards the goal, and hence consumer motivation and choice.

Drawing on the above findings, we argue that “points” serve as a metering device for consumers to track and evaluate progress in a loyalty program. The current paper contributes to the literature on loyalty programs by investigating the impact of complexity. Here we use complexity to reflect the number of mediums in a reward program. For instance, a multi-medium reward program such as “Expenses$Points$Vouchers$Rewards” will be regarded as more complex than a single medium program like “Expenses$Points$Rewards.”

More importantly, we suggest that a complex reward program actually enhances the perception of progress by breaking down a seemingly large goal (N points) into a number of smaller, more attainable sub-goals (Locke and Latham 1990). As a result, we expect that consumers in a complex reward program will find it more attractive, resulting in increased purchases of the brand offering it. In a dynamic decision situation, we predict that consumers in a complex program tend to be more “obsessed” with collecting points, and hence tend to achieve their final goal earlier.

We first propose an analytical model that captures consumers’ evaluation of points in a loyalty program. Assuming that the value consumers derive from the reward is independent of the value gained from perceived progress, we formulate the perceived value of progress from x reward points as follows:

$$F(x, V_{\text{voucher}}) = [\eta(x) + \rho(x_v)], V_R$$

where $V_{\text{voucher}}=1$ for reward programs with a voucher; 0 for programs without vouchers; $\eta(x)$ is the consumer’s perceived cumulative progress when the reward program does not offer vouchers; $\rho(x_v)$ is a consumer’s incremental valuation for x reward points due to the presence of vouchers, and $x_v$ is the number of vouchers from x reward points. Finally, $V_R$ denotes a consumer’s evaluation of reward R.

We will present the results from two studies comparing single-medium and multi-medium programs. In the first study, participants are asked to make a series of choices between two brands. This experiment is designed to test how participants’ relative preference for two alternatives is impacted by (1) the presence of vouchers and (2) the number of points already accumulated, which is a within-subject factor.

We find that (1) the presence of vouchers increases the perceived value of progress from additional reward points. Consumers are more likely to shop at a store that has a complex program, rather than at the store that simply awards points for expenses; (2) the use of vouchers does not change the perceived value of progress from additional reward points when a consumer has not collected any vouchers yet or when a consumer can reach the goal within a new purchase. These results were successfully replicated in a follow-up between subjects experiment.

In our second study, we put participants in a real dynamic decision making scenario. Instead of choosing between two brands, the participants need to decide whether to work hard on a main task to earn some extra money or to do an enjoyable (distracting) task without extra payment. The main task is a proof reading task, in which participants need to finish 50 pages of proof reading. There are two between subject factors: (1) the complexity (voucher vs. no voucher) of a reward program; (2) motivation level (high vs. low). The motivation level is manipulated by offering different incentives (low=$3 vs. high=$8). We predict that when the incentive is low, participants in complex reward programs will work harder on the boring proof reading task than participants in the simple reward program. However, since we argue that the vouchers influence consumers by providing extra motivational value, the difference between simple and complex reward programs should be eliminated in the high motivation condition.

“Too Close to Quit: The Effect of Reward Fungibility on Consumer Purchase Intentions”
Joseph C. Nunes, University of Southern California
Xavier Drèze, University of Pennsylvania

The increasing popularity of loyalty programs has given rise to dozens, if not hundreds of alternative currencies, including frequent flier miles, hotel points and credit card rewards. Many of these mediums of exchange are uniform, divisible and storable on their own, and can be exchanged for particular goods and services of the firm’s choosing, and that the consumer desires. While the ability for consumers to utilize these currencies in new ways is growing rapidly, the amounts that they can spend in any single
transaction and the products they can acquire are still severely limited and controlled almost entirely by the firm issuing the currency. In this sense, alternative currencies are unlike legal tender in that their use is constrained; in other words, these currencies are not perfectly fungible. Indeed, these alternative currencies are neither universally accepted nor can they be spent in any increment, thereby restricting the ways in which consumers can expend these assets.

We propose that this complexity, or lack of fungibility, allows the firm to influence strategically the marginal values of the alternative currency it issues, which affects consumers’ motivation to acquire more of the currency, which in turn motivates purchase decisions and ultimately influences consumer loyalty. In other words, the effectiveness of reward programs depends on the number of rewards offered and the amount of the alternative currency required to redeem each reward, both of which are decided by the firm. Consider the following illustrative, yet somewhat artificial example. An individual has accumulated 30,000 frequent flier miles on an airline that offers only one reward, a free round-trip ticket for 25,000 miles. After cashing in 25,000 miles, she is left with 5,000 miles. At this point, another 3,000-mile flight would mean little as 20,000 more miles on the same airline, a non-trivial amount, are required before her inventory is useful and subsequent purchases are rewarded. Thus, the 5,000 miles already in her account are inherently worthless and wasted if she switches carriers permanently.

However, if the airline were to offer a free upgrade at 10,000 miles, this award may be tempting enough to secure this flyer’s next purchase of a roundtrip ticket, particularly one from Boston to Los Angeles (5,200 miles). But if the airline offered rewards in exchange for 5,000 miles (the least complex and most fungible option mentioned), it would be easy enough for this consumer to expend her remaining miles such that her inventory might have no effect on her choice of carrier in the future. Therefore, the value of miles accrued and yet to be earned depends on the rewards offered and the amount of miles required to redeem the rewards; in other words, their fungibility. Rewards that require effort but seem attainable are motivating, while rewards acquired too easily appear gratuitous and are uninspiring.

The primary purpose of the present research is to improve our understanding of loyalty programs. More specifically, we examine how different reward schedules affect consumer goal setting and purchase decisions (i.e., loyalty). A fundamental premise underlying this research is that frequency program rewards serve as incentives or goals that motivate consumers to continue purchasing from a particular seller or supplier. We believe that consumer response to rewards offered by loyalty programs is a function the reward’s value (how much the goal is valued), the number of rewards *sub-goals) offered, as well as the perceived difficulty associated with reaching the various rewards (goals). Simpler programs are typically more fungible (any amount can be exchanged for stock goods), while complex programs are typically less fungible (more disparate rewards levels and less uniform rewards).

In Study 1, we demonstrate how rewards levels can affect people’s purchase behavior. We show that consumers closer to earning a reward (their goal) are perceived as more likely to make an additional purchase, even though the incremental purchase, while bringing them even closer to the goal, is not enough to reach it. In Study 2, we show that when consumers are far away from a big goal, we can increase their likelihood of purchase by increasing the fungibility of the reward system (i.e., inserting a sub-goal or smaller reward that appears more attainable). We also show that inserting attainable rewards increases the marginal value of an alternative currency for those with no immediate exchange opportunities, but does not diminish the value for those holding a surplus and are closing in on a superior reward. In Study 3, we test the limits of the positive effect of fungibility on motivation and show that too much fungibility can actually be de-motivating. We also examine how goals affect effort differently depending on whether people are above or below a goal, and whether success in achieving one goal engenders complacency or further motivates the person towards achieving the goal a second time. While in Studies 1 through 3 we explore how consumers respond to choices that can move them closer to their goals, in Study 4, we look at actions that move consumers away from their goal rather than closer. We find that fungibility also affects consumers when their choices can move them away from a goal.

Taken together, these studies provide convergent evidence supporting the proposed notion that rewards can serve as goals, and that the value consumers ascribe to an alternative currency depends on their proximity towards achieving a goal. As such, this is the first research to test the effects of increasing and decreasing fungibility on both the valuation of an alternative currency and the continued patronage necessary to continue accruing the currency (i.e. loyalty). Theoretically, this work adds to the marketing literature by connecting the goal literature with the promotions literature and illustrating how loyalty programs that utilize rewards create extrinsic goals for consumers. We also advance the goal literature by exploring the effects of increasing and decreasing the number of goals, or in our words, increasing the fungibility of an alternative currency. We show how attainable goals can increase the marginal value of an alternative currency, which motivates consumers to act such that they accumulate more of the currency. However, we also show how too much fungibility (too many small goals) can decrease motivation and negate the effectiveness that larger more difficult rewards can have in stimulating loyalty.

REFERENCES


