

Customer loyalty programs: are they fair to consumers?

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Abstract

Purpose – The purpose of this paper is to examine the fairness of loyalty programs to consumers regarding two emerging criticisms of loyalty programs: discriminating value proposition segmentation and potential exploitation of captured personal information.

Design/methodology/approach – Equity theory and exchange theory are the theoretical foundations used for evaluation of the aspects of loyalty program fairness.

Findings – First, through the application of equity theory, firms can more effectively recognize and reward more valuable customers without alienating less valuable customers. Second, through the use of exchange theory, firms can secure authorization to collect and use individual customer information from customers in exchange for enhanced value proposition offerings via loyalty programs. Loyalty programs can induce customers to give up their personal information in exchange for benefits they would not otherwise receive. Marketers use the higher level of benefits available through loyalty programs as a form of compensation to customers for sharing personal information.

Practical implications – Customer loyalty programs that are equitably administered and thoroughly communicated will be perceived favorably by consumers.

Originality/value – This paper marks the first study to examine the issue of consumer fairness as it relates to how firms use loyalty programs to collect proprietary information and differentiate value propositions among customer segments. The findings can be used by managers to strengthen the marketing position of the firm through a loyalty program without compromising on their customers' perceptions of fairness.

Keywords Loyalty schemes, Equity theory, Exchange, Customer relations

Paper type General review

Introduction

The popularity of customer loyalty programs has attracted widespread attention among marketing scholars in recent years (e.g. Kivetz and Simonson, 2002; Nunes and Dreze, 2006; Roehm *et al.*, 2002; Uncles *et al.*, 2003). Much of the research has been directed towards investigating how these programs contribute to the firm's financial and market performance (e.g. Bolton *et al.*, 2000; Kim *et al.*, 2004; Lewis, 2004; Sharp and Sharp, 1997) and their ability to cultivate customer loyalty (e.g. Dowling and Uncles, 1997; O'Malley and Prothero, 2004; Uncles *et al.*, 2003). Despite the abundance of customer loyalty program research – and emerging perspective that firms must move from their traditional position of providing all participating customers with equivalent benefit enhancement offerings – few studies have evaluated aspects of program fairness and privacy from the customer's vantage point.

While critics of loyalty programs argue that marketers should strive to enhance the value proposition for every customer, the nature of customer loyalty programs is such that tiered levels of benefits and customer services are created. Furthermore, programs that target specific customers or

customer segments in order to reward customer loyalty will require even greater value proposition differentials among customers and more precise market segmentation than currently exists with most loyalty programs. Firms that utilize these programs are explicitly shifting resources away from non-participating customers in favor of customers who participate in their loyalty programs, which may lead to accusations of discriminatory customer treatment. For customers who participate in loyalty programs, there is potential for increased concern about the misuse of personal information and loss of control over how information is being collected and disseminated (Langenderfer and Cook, 2004), given that current regulatory measures designed to protect consumer information privacy may not be sufficient (Petty, 2000). Meanwhile, the collection and use of information that can favorably impact the longevity and profitability of customer relationships is often dependent upon consumers' voluntary participation in these programs.

To our knowledge, no published work has examined the issue of consumer fairness as it relates to how firms use loyalty programs to collect proprietary information and differentiate value propositions among customer segments. This is a critical gap in the literature because loyalty programs continue to be used by organizations as marketing tools to support their customer relationship management (CRM) strategies. For example, the firm may use loyalty programs to focus directly on building loyalty, cultivate higher retention rates among its most valuable customers, and/or focus on data collection from individual customers. It is not the purpose of this analysis to explain the marketing objectives of individual firms, but rather to examine the fairness of such programs to the firm's customers at a macro level. This study will briefly describe the

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growing popularity of loyalty programs as a focal marketing tool. Next, it will present the two emerging major criticisms of loyalty programs: discriminating value proposition segmentation; and potential exploitation characteristics regarding personal information disclosure, and examine their respective relationships with equity theory and exchange theory. Finally, key findings and managerial implications resulting from this investigation will be presented.

Emergence of loyalty programs

Customer loyalty programs are coordinated, membership-based marketing activities designed to enhance the building of continued marketing exchanges among pre-identified customers toward a sponsoring brand or firm. Loyalty programs use targeted communications and customize the delivery of branded goods and services to build stronger bonds with the sponsoring brand/firm than would result without such programs. Often based on cumulative brand purchases, loyalty programs enhance value proposition offerings to preserve active customer status. Loyalty programs are set apart from other forms of promotions by their long-term nature and deliberate emphasis on preserving customer retention and intensifying purchase frequency (Sharp and Sharp, 1997).

The history of loyalty programs can be traced back to 1896, with the introduction of S&H Green Stamps. By the 1960s, S&H Green Stamps was the largest purchaser of consumer goods in the world. Since the decline of popularity of stamp reward programs, newer generations of loyalty programs have gained widespread appeal. The first modern loyalty program was instituted by the airline industry when American Airlines introduced its frequent flyer program in 1981. During the technology boom of the 1990s, loyalty programs grew exponentially in the USA and throughout much of the economically developed world. According to a 2000 Jupiter Research study, 75 percent of US consumers participated in at least one loyalty program (Colloquy, 2000). In a 2005 AC Nielsen survey, nearly all Canadians (97 percent) participate in at least one loyalty program (AC Nielsen, 2005). Other highly mature loyalty program markets outside North America include the UK and Australia.

Customer loyalty programs are utilized across a broad spectrum of vertical consumer markets, including hotels, credit card issuers, retailers, airlines, car rental companies, and entertainment firms. Deregulation trends in the cellular telephone and cable television industries suggest that commodity-based firms will increasingly utilize loyalty programs to attract and retain customers. Since firms across different industries share many of the same customers, many loyalty programs have also begun to adopt multiple branding schemes through which customers are able to combine and transfer program benefits. Multiple brand loyalty programs can occur between firms or within a corporate conglomerate (e.g. Starwood Hotels & Resorts, InterContinental Group), with the latter serving as an enterprise-wide program of a customer's total marketing relationship with an organization. Extremely popular in Canada and the UK, loyalty programs supported by multiple participants offer increased customer value by accommodating a broader scope of business and organizational value due to the sharing of program costs (Swaminathan and Reddy, 2000).

Tiered value propositions

Marketers faced with the business reality of limited firm resources are challenged by the desire to better serve their most valuable customers without overtly discriminating against less valuable customers. Because all customers are not equally valuable, it may be neither economically nor operationally wise to expand the firm's value proposition to all of its customers (Reichheld, 1996). Failing to consider customer value may result in firms' wasting resources oversatisfying less valuable customers, while under-satisfying those with greater value (O'Brien and Jones, 1995). While many marketers aggressively leverage segmentation through loyalty programs that explicitly reward their most valuable customers, such actions may discriminate against other patrons by channeling more resources toward the discriminating needs and desires of its most valued customers.

Value discrimination results from firm activities which award select customers with elevated social status recognition and/or enhanced products and services above and beyond what is normally offered to customers. As an expansion of the marketer's value proposition, loyalty programs can be designed to accommodate individual consumers in the form of added products or enhanced customer service options not generally presented to all of the firm's customers. For example, personalized customer service can recognize select program members and handle each of the customers belonging to this category on an individual basis. Clearly, loyalty programs can be used to convey prestige to customers and make them feel special, important, and appreciated (Morgan *et al.*, 2000). However, the effect on the firm's nonparticipating customers can lead to dissatisfaction and alienation with the firm. Moreover, customers who participate in the program might become frustrated, and perhaps even disenfranchised, due to their inability to benefit from these programs (Dowling and Uncles, 1997).

Equity theory

Fairness and/or discrimination in customer loyalty programs can be examined using equity theory (Huppertz *et al.*, 1978). According to this theory, equity is viewed as something that is fair, right, or deserving in comparison to other entities, whether real or imaginary, individual or collective, person or non-person (Oliver, 1997). Equity should not be confused with equality, which calls for all customers to receive the same value proposition regardless of individual contributions. According to equity theory, customers form perceptions of the inputs (i.e. money, time, effort, opportunity costs) and outputs (e.g. tangible and intangible benefits) that are associated with an exchange. In this section, the fairness of value proposition discrimination practices commonly found in customer loyalty programs is discussed relative to three well-established aspects of this theoretical base, i.e. distributive equity, procedural equity, and interactional equity. A summary of customer perceptions and potential sources of discrimination are presented in Table I.

Distributive equity

Distributive equity is the extent to which customers perceive that they are equitably rewarded for their input (Oliver and Swan, 1989). Customers assess fairness of an exchange by comparing inputs to outcomes. An exchange is judged to be fair when customer input (what the customer is willing to invest) is proportional to outcomes associated with the exchange. Equity is said to exist when the perceived inputs

Table I Assessing fairness of value proposition discrimination in customer loyalty programs

Form of equity	Customer perceptions of equity	Sources of perceived inequity
Distributive equity	Customers perceive there is fairness in the rewards they receive in return for their input	Needs and desires of different market segments Usage rate often linked to rewards Observing how other customers are treated Rising expectations and demands for greater rewards
Procedural equity	Customers perceive there is fairness in the process or means by which reward allocation decisions are made	Nonstandardization of loyalty programs Changing rules Nonportability of programs Inaccurate and/or inadequate consumer information Variability in response to individual requests
Interactional equity	Customers perceive there is fairness in the exchange of information and communication of outcomes	Treatment of customers Delivery of the value proposition Inconsistency across interactions Communication of mechanics and program criteria

and/or outcomes received by an individual consumer are psychologically consistent with the perceived inputs and/or outputs of similar customers (Huppertz *et al.*, 1978). A major motivation for behavior is the anticipation of maximizing one's own outcomes. This helps to explain, in part, why customer loyalty program participants often forgo freedom of choice in brand, firm, or service provider selection – or even pay some form of entry fee – in exchange for the benefits available from the loyalty program. Program benefits are commonly grouped into two categories: tangible or “hard” benefits and intangible or “soft” benefits. Hard benefits are comprised of tangible rewards, such as product offerings, gifts, special deals, price discounts, and cash incentives. Soft benefits are intangible and relationship-oriented, dominated by various forms of customized communications and preferential treatment. Examples of preferential treatment might include special access to private lounges for travelers, priority service at restaurants, special retailer events invitations, expedited check-in and check-out at hotels, and rental car upgrades. Soft benefits hold greater potential for program distinction for many successful loyalty programs (Hennig-Thurau *et al.*, 2002).

Customers' perceptions of distributive equity increase when it is perceived that the firm is exerting extra effort by offering enhanced value propositions. Customers will consider the balance of their own inputs and outcomes compared to those received by other customers who are deemed to be of similar stature (Xia *et al.*, 2004). As such, customers' criteria for evaluating distributive equity come from observations of how other customers are treated. Although many loyalty programs strive to achieve distributive equity, the application of such programs may create perceptions of inequity and dissatisfaction and negative consequences can result. This is more likely to occur in settings where customers regularly interact with other customers and are able to observe superior value propositions being awarded. Through the separation of value proposition variables, firms are essentially transferring value from nonparticipants to program participants and rewarding loyalty program members at the expense of nonmember customers. Since many loyalty programs are targeted towards customers in the heavy-user segment of a particular product or service, heavy users often stand to gain the most from these programs. In contrast, light users generally do not benefit from loyalty programs (Kim *et al.*, 2001).

Procedural equity

Procedural equity involves the fairness of the process or means by which reward allocation decisions are derived. It represents the fairness of the process that leads to the outcome (Thibaut and Walker, 1975), including consistency of application in policies, procedures, and other criteria used to determine the results (Blodgett *et al.*, 1997). According to Shugan (2005), customers can be discouraged from actively participating in loyalty programs due to their nonstandardized nature, especially when they are difficult to evaluate, have changing rules and regulations, and lack portability.

It is of critical importance to procedural equity that reward allocation decisions be based on accurate customer information. While allocation processes should be unbiased, Tax and Brown (1998) argue that procedural equity should consider circumstances and requirements of individual customers. However, equity for one consumer group resulting from program membership may create sentiments of inequity among nonparticipating customers. Some researchers have advised marketers to use caution in their flexibility to individual requests to ensure that such actions do not create feelings of inequity for other customers (Tax and Brown, 1998). On the other hand, if nonmember customers perceive that the value proposition to qualifying members as unbiased, impartially delivered, and consistent with the standards of the program, they are likely to perceive procedural equity. Indeed, in such cases, nonmembers may perceive that outcomes directed to program members are unfair, yet still assess the procedures used to derive such treatment as equitable.

Interactional equity

Interactional equity considers the fairness associated with the exchange of information and communication of outcomes (Goodwin and Ross, 1992). Customers evaluate how processes are implemented and the way in which the processes and outcomes are explained. Associated with interpersonal treatment (Maxham and Netemeyer, 2003), interactional equity focuses on the two-way flows between customers and marketers, including the manner in which the customer is treated in terms of respect, interest, friendliness, honesty, and politeness. Even when customers perceive that outcomes and procedures are equitable, they may still feel mistreated if they discern unfair status treatment due to the manner in which the marketer delivers the value proposition.

A danger of loyalty programs is that consumers may feel slighted when their interactions with the firm are inconsistent with what they believe is deserved.

Potential for interactional inequity can be reduced through open and extensive communications. Loyalty programs frequently engage in recognition and personalization through extensive communications with participating members. For some firms, loyalty program communications occur as one component of a more comprehensive communications effort (Roehm *et al.*, 2002). For other firms, loyalty programs are the primary vehicles used to create a sense of community and establish meaningful dialogue with its best customers in order to develop customer relationships. With many loyalty programs, members are regularly sent newsletters, direct mail, and e-mails. It is often through loyalty program-sponsored web sites that the marketer has its best opportunity to engage in ongoing communications with its customers through account information and customized content.

Capturing individual consumer information

The ultimate marketing objective behind many loyalty programs is their use as a primary data-gathering platform that can help to improve the efficiency and effectiveness of a firm's marketing initiatives (Uncles *et al.*, 2003). Often the firm's most robust source of behavioral data, loyalty programs allow marketers to capture detailed transactional and preference customer databases. These databases can be used to determine customer value, define specific marketing strategies for finite customer segments, and model customer attrition and intervention strategies. Recent developments in telecommunications and customer database technology have provided unprecedented power to marketers attempting to build and aggregate customer information systems and assemble in-depth, enterprise-wide portraits of individual consumer purchasing behaviors (Nunes and Dreze, 2006).

Perhaps the greatest benefit obtained from loyalty programs resides in the data mining and knowledge base that firms can use to develop statistical models to improve customer loyalty, support customer service, and develop new offerings to help reduce defection and increase customer lifetime value (Wansink, 2003). Discriminating value proposition offerings demands individualized customer information. Armed with customer-specific information, firms are able to direct and tailor their communications and optimize product mix offerings. Thus, loyalty programs represent an alternative to mass-market promotion since firms have the ability to more precisely target an increasingly fragmented customer base, and communicate customized and relevant value propositions and marketing messages to individual customers.

At the same time that firms are engaging in an unprecedented collection of individual customer information, consumers are becoming increasingly concerned about their privacy and how personal information is being used and disseminated (Zabin and Brebach, 2004). Information privacy exists when an individual can limit accessibility and control the release of information about oneself (Westin, 1967). Invasions of privacy occur when there is loss of control resulting from marketing exchanges (O'Malley and Prothero, 2004). Recent corporate mismanagement scandals and fears of technology abuse have only fueled personal privacy concerns (Sarathy and Robertson, 2003), and some customers resist trading in their privacy and data security unless compelling benefits are offered. Furthermore, consumers' propensity to divulge

discretionary personal information depends on the existence and strength of a marketing relationship with the firm (Sheehan and Hoy, 2000), and is influenced by the purpose for which information will be circulated within and outside the firm. Although personal privacy concerns depend largely on the type of information being collected and how it will be used (Nowak and Phelps, 1992), customers routinely cooperate with marketers' request for personal information that they perceive is necessary to complete the marketing exchange.

Exchange theory

Customers and firms engage in exchange for a variety of reasons, including those that are economic and social in nature. Marketing exchanges typically involve the transfer of resources such as goods, services, and/or money (utilitarian exchange), as well as the symbolic aspects of exchange, e.g. social rewards (Levy, 1959; Bagozzi, 1975). Historically, information disclosure has been linked to exchange theory (Hirschman, 1980) whereby consumers are willing to exchange their personal information in order to obtain other resources, such as monetary savings or enhanced services. Exchange theory also posits that individuals will trade personal information for other resources during marketing transactions, including love, status, money, goods, and services (Brinberg and Wood, 1983). Resources being exchanged must be valued by the parties to the exchange, with scarce resources having greater value than those that are readily obtained (Brinberg and Castell, 1982). In the case of loyalty programs, participating customers are offered an enhanced value proposition, and in return firms will be given access to personal information that can be used to further refine strategies and tactics.

In general, members to the exchange will attempt to coordinate efforts and cooperate with each other (Stern, 1969; Wilkinson, 1974). Although individual consumers have shown a general willingness to disclose information about themselves when they believe they will receive benefits in return (Milne and Gordon, 1993), they also consider the nature of the benefit being offered when deciding whether a request for information violates their personal privacy (Westin, 1967). In the paragraphs that follow, the fairness of capturing and using customer information via customer loyalty programs is discussed in terms of three types of exchange, i.e. restricted exchange, generalized exchange, and complex exchange. Perceptions of equity and sources of inequity concerning the collection and use of personal information are summarized in Table II.

Restricted exchange

In a restricted exchange, two parties are engaged in a reciprocal relationship. Both parties seek to maintain equality and balance in their dealings, particularly when the exchange relationship is ongoing (Bagozzi, 1975). Implicit to this type of exchange is the notion that undue advantage or deception by one party may limit subsequent exchange opportunities. In addition, it is assumed that both parties will exchange something of value ("quid pro quo") and that benefits being exchanged should be similar (Brinberg and Castell, 1982). By agreeing to join a loyalty program, customers are, in effect, giving the firm their approval to collect and use discretionary personal information in order to execute the enhancement of products or services that may result from participating in the loyalty program. Marketers essentially use the higher level of benefits achieved through loyalty programs as compensation

Table II Assessing fairness in data collection and use in customer loyalty programs

Type of exchange	Customer perceptions of equity	Sources of perceived inequity
Restricted exchange	Customers perceive there is fairness in the exchange when both parties are equal and directly benefit from the relationship	Customers who wish to maintain privacy Misuse of information Insufficient compensation for personal information
Generalized exchange	Customers perceive there is fairness in the exchange when all parties to the exchange indirectly benefit from the relationship	"Opt-out" standard Sharing personal information with outside parties Insufficient "quid pro quo"
Complex exchange	Customers perceive there is fairness in the exchange when all parties to the exchange directly or indirectly benefit via a system of interconnected relationships	Lack of coordination Incomplete information Dissimilar benefits being exchanged Individualistic behavior

to customers who share personal information (Schultz and Bailey, 2000).

In return for personal information, it is important that customer loyalty programs offer benefits that will lead to continued exchanges and disclose how information being collected will be used. Unless both parties are exchanging something that is perceived as having equal value, future attempts to engage in exchange will be limited. Consumers are most likely to participate in programs they believe offer equitable relationships and will, ultimately, base their decision to participate in loyalty programs according to their perceptions of fairness. Most loyalty programs offer their members assurance that the firm will take reasonable precautions to prevent the misuse of personal information, and indicate they will not suffer negative consequences as a result of disclosing proprietary information. Even so, some customers may choose to sacrifice membership – and membership rewards – to protect their personal information. Unless rewards of sufficient value can be offered in return for information, there is also a risk these customers may perceive that the firm is penalizing nonparticipating customers who wish to maintain their privacy (Introna and Pouloudi, 1999).

Generalized exchange

Generalized exchanges involve three or more parties, in which benefits from the exchange are realized indirectly. Unlike restricted exchange, it does not involve the direct exchange of one thing of value for another. A party to the generalized exchange may give up something of value to another party, but will receive benefits from someone else. Generalized exchanges such as the sale of electronic databases across firms and/or industries enables firms to develop and communicate relevant value propositions and marketing messages, increasing efficiencies and reducing costs for all parties to the exchange. However, it is important that the firm discloses its information practices and informs customers how the data will be collected, used, and shared. With few exceptions the default assumption for information collected through loyalty programs is the "opt-out" standard, in which firms use individual consumer marketing information unless the customer says otherwise. By contrast, under an "opt-in" standard, data are kept private unless the customer explicitly gives permission to use and/or share his or her personal information. Because it is often the firm and not the consumer that controls personal information (Langenderfer and Cook, 2004), firms pursuing long-term relationships through customer loyalty programs might wish to consider

actively soliciting customers' permission in advance of transferring data to other firms for use in direct marketing.

Complex exchange

The final form of exchange, complex exchange, involves a system of three or more exchange partners, each of whom is involved in one or more direct, or indirect, sequential exchanges (Bagozzi, 1975). In complex exchanges, coordination among the parties to the exchange is important, since parties may receive direct or indirect benefits from more than one member in the system. For multiple brand loyalty programs – those that are supported by multiple firms or within a corporate conglomerate – the rewards are often provided by someone other than the party involved in the original exchange. In addition to the potential for perceived imbalance in the exchange, customers may not understand that personal information will be shared with other exchange partners, even though direct benefits may never be sought, let alone used, by each of the parties. Furthermore, since complex exchanges often include indirect exchange, it is possible that benefits being exchanged may be dissimilar, and/or that one or more parties to the exchange will act in their own self-interest. Consequently, firms may offer loyalty program benefits that are not valued, causing some customers to reject efforts to engage in future exchange and others to feel under-compensated for information they have made available.

Summary

Loyalty programs are facing mounting pressure concerning their use as a facilitator of specific customer information and potential to discriminate against non-member customers because of greater marketing resource allocations shifted toward selective customers. This study has examined how firms may be in a position to manage these perceptions through the practical application of equity theory and exchange theory. In doing so, the authors have attempted to address a notable gap in customer loyalty program literature, namely the lack of research concerning fairness of loyalty programs in terms of their potential for value proposition discrimination and personal information exploitation.

Previous studies have focused on assessing loyalty programs' effects from the firm's perspective, typically on the value of customer relationships and strengthening financial performance. Grounded on seminal marketing theories, this paper has presented two important research contributions through an examination of the fairness of loyalty programs from the customer's point-of-view. First,

through the application of equity theory, we offer instruction to marketing managers for how they can effectively manage different tiers of customers, driven by customer equity, without alienating less valuable customers. Second, through the use of exchange theory, we have attempted to shed insight regarding how firms can secure authorization to collect and use individual customer information from consumers in exchange for enhanced value proposition offerings via voluntary loyalty programs. By taking full advantage of these lessons, managers can use loyalty programs to strengthen their marketing positions without compromising on their customers' perceptions of fairness.

Managerial implications

Despite the emerging criticisms highlighted concerning loyalty programs, the application of equity theory to marketing managers suggests that customers' perceptions of distributive equity can, in fact, be strengthened by enhanced value propositions made available through such programs. But it is paramount for marketing managers to use open and extensive communications to manage the perceptions of procedural, interactive, and distributive equity among all customers of the firm. Perceptions of distributive inequity are likely to be influenced when members enjoy superior treatment and/or amenities that are visible to non-member or non-qualifying customers. However, if the procedures used to determine enhanced value propositions are based on criteria that are unbiased, impartially delivered, and consistent with the standards of the loyalty program, all customers, including those who do not choose and/or are ineligible to participate in the loyalty program will more readily accept the firm's employment of such programs and perceive them favorably. Another hallmark of an equitably administered loyalty program is that its participating customers recognize the level of consistency in how they are treated relative to how they believe they deserve to be treated. Thus, the fairness of discriminating value propositions delivered through loyalty programs must be in proportion to customer inputs with clear and straightforward information about the mechanics of its selection criteria and program rewards.

Marketing managers should also consider the potentially valuable role loyalty programs play in not only collecting customer information but also how these programs can be used as the formal system for marketing managers to induce consumers to voluntarily share their personal information in exchange for benefits they would not otherwise receive. Much like equity theory's relationship to value proposition discrimination, exchange theory provides guidance to marketing managers by suggesting that information gathering and use may be "fair" as long as there is perceived equity across exchange relationships. The membership-based attribute of loyalty programs can be devised to secure customer permission that allows the firm to assemble an individual customer profile that can then be used to assess the potential value of each member and help determine marketing's efforts to realize their potential value.

The managerial implications of exchange theory to assess fairness of loyalty programs is also key to reducing privacy concerns in the current regulatory climate (as well as in the future) should firms become subject to mandatory opt-in regulation requirements. Though it is often not necessary that firms receive explicit customer approval to collect and use individual-specific information, these activities continue to attract criticism from privacy advocates. Due to this increased

scrutiny, firms that have already secured consumers' permission to collect personal information, and are providing appropriate benefits in return for that information, appear to be better positioned should a major shift occur in privacy laws or attitudes toward loyalty programs.

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