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MARKET RESEARCH AND ECONOMIC ANALYSIS, EXPLORING THE DEMAND ESTIMATION.

Petra Haddadin Oghlanian[1],
[1] *School of Business, American International Theism University, Florida, USA*
Email: petra.ogh@gmail.com

Abstract: *In those days, market research and economic analysis work with various methods of Demand Estimation, by explaining what demand estimation is and how it involves in determining the quantity of a product or service that consumers are willing and able to purchase at different prices, with some limitation on the data collection methods.*

Understanding how decision-makers are using Regression Analysis to determine the demand forecasting and the potential challenges that they are facing in using regression analysis for forecasting.

Discussing the two concepts of demand forecasting, Returns to Scale and Cobb-Douglas, and how they relate to a firm's long-term production decisions. Also, understanding the Opportunity Cost and how it differs from economic profits by giving a practical example.

Also, illustrating the distinction between fixed costs and sunk costs, the meanings and the types, is very helpful for better decision-making.

1. Introduction

Demand estimation is a critical aspect of market research and economic analysis that involves determining the quantity of a product or service that consumers are willing and able to purchase at different prices. Various methods can be used to collect data for demand estimation, including consumer surveys and controlled market studies, and they can be used individually or in combination, depending on the research objectives and available resources. Here's an overview of these methods:

1.1. Consumer Surveys: Consumer surveys involve collecting data directly from potential consumers through questionnaires, interviews, or online forms. These surveys aim to gather information about consumer preferences, buying behavior, and willingness to pay for a product or service (Hair and Others, 2014).

1.2. Controlled Market Studies: Controlled market studies, also known as field experiments or controlled experiments, involve manipulating one or more variables in a controlled environment to observe how changes affect consumer demand. This method is often used to assess the impact of pricing strategies or other marketing interventions (Briesch, 2010).

1.3. Secondary Data Analysis: Secondary data analysis involves using existing data sources, such as government reports, industry publications, or data from previous studies, to estimate demand. Researchers analyze and interpret these data to gain insights into consumer behavior and market trends (Malhotra, 2007).

1.4. Observational Data and Scanner Data: Observational data collection involves tracking and recording actual consumer purchases and behavior. Scanner data, collected at point-of-sale terminals, provide detailed information on product sales, prices, and consumer choices (Blattberg, 2012).

2. Effectiveness and Limitations of Data Collection Methods

2.1. Consumer Surveys

i. **Effectiveness**: Consumer surveys are effective when you want to understand consumer preferences, willingness to pay, and buying behavior. They are suitable for exploring a wide range of products and services and can provide insights into customer demographics.

ii. **Limitations**: Survey responses may be influenced by social desirability bias, leading to inaccurate or incomplete information. Response rates can also be low, and surveys can be time-consuming and costly (Hair and others, 2014).

2.2. Controlled Market Studies

i. **Effectiveness**: Controlled market studies are highly effective when assessing the impact of specific interventions, such as pricing strategies or marketing campaigns, on consumer demand. They allow for controlled manipulation of variables.

ii. **Limitations**: These studies can be resource-intensive and time-consuming to set up. Findings may not always generalize to real-world conditions, and ethical considerations must be addressed (Briesch, 2010).

2.3. Secondary Data Analysis

i. **Effectiveness**: Secondary data analysis is useful when historical data or data from external sources are available. It can be cost-effective and time-saving for estimating demand trends.

ii. **Limitations**: The quality and relevance of secondary data can vary. It may not always align perfectly with specific research objectives, and researchers may have limited control over data collection methods (Malhotra, 2007).

2.4. Observational Data and Scanner Data

i. **Effectiveness**: Observational data and scanner data are effective when studying actual consumer behavior and purchase patterns. They offer real-world insights into product sales and pricing dynamics.

ii. **Limitations**: These data sources may not capture all relevant variables, and access to scanner data can be limited. Interpretation may require expertise in data analysis (Blattberg, 2012).

3. Regression Analysis for Demand Forecasting

In demand forecasting, regression analysis can be valuable for businesses aiming to make data-driven decisions about pricing, inventory management, marketing strategies, and production planning. By understanding how different factors influence demand, organizations can optimize their operations and respond effectively to market dynamics (Montgomery, 2012). Demand forecasting, price elasticity estimation, sales prediction, and market response analysis are common applications of regression analysis in business and economics.

Regression analysis is a statistical method that examines the linear relationship between a dependent variable (product demand) and one or more independent variables (price, advertising expenditure, economic indicators). By analyzing historical data, regression models can be used to estimate how changes in these independent variables affect demand (Montgomery, 2012).

3.1. Steps to Regression Analysis

i. **Data Collection:** The process begins by collecting historical data on the dependent variable (demand) and one or more independent variables (factors that may affect demand) (Montgomery, 2012). For example, in demand forecasting, you might collect data on past sales (demand) and various factors such as price, advertising expenditure, seasonality, and economic indicators.

ii. **Model Selection:** You select an appropriate regression model based on the nature of the data and the relationships you want to explore. In simple linear regression, there is one independent variable, while multiple linear regression involves more than one (Montgomery, 2012).

3.2. Model Estimation:
The regression model estimates the relationship between the independent variables and the dependent variable. It calculates coefficients for each independent variable, indicating the strength and direction of their impact on the dependent variable, a formula of simple linear regression is :

Source: (Damaris, 2020)

$$\hat{y} = b_0 + b_1 x$$

Where :

$\hat{y}$	= dependent variable
x	= independent variable
b_0	= intercept (α)
b_1	= regression coefficient (β)

i. **Prediction:** Once the model is established, it can be used to make predictions. By inputting values for the independent variables (e.g., future prices, and advertising budgets), the model can estimate future demand levels based on the established relationships (Montgomery, 2012).

ii. **Evaluation:** The model's accuracy and reliability are assessed using various statistical metrics (e.g., R-squared, Mean Absolute Error) and diagnostic tests to ensure it provides meaningful predictions (Montgomery, 2012).

Regression analysis is valuable for predicting future demand due to its quantitative assessment of the relationship between variables, prediction, identifying significant factors, understanding price elasticity, optimizing marketing efforts, and identifying trends in historical data. It aids businesses in making data-driven decisions, guiding resource allocation and marketing efforts, and aiding in long-term demand forecasting and strategic planning (Montgomery, 2012).

3.3. Returns to Scale

Returns to scale is a concept from economics that refers to how a change in the scale or level of production in a business or industry affects its output or returns. In the context of demand forecasting, returns to scale typically focus on the relationship between changes in production or output and the corresponding changes in costs or revenue. This concept helps businesses understand how their production decisions can impact demand and profitability (Pindyck, 2017). Returns to scale measure the percentage change in output resulting from a given percentage change in inputs. There are three important cases:

i. **Increasing Returns to Scale**: When a business experiences increasing returns to scale, an increase in production results in a proportionally larger increase in output or revenue. In other words, as production scales up, the cost per unit of production decreases, and revenue increases at a faster rate. This situation often occurs in industries with significant economies of scale, such as manufacturing (Pindyck, 2017). **Example:** A small bakery produces 100 loaves of bread a day, and its total daily production cost is $200. If the bakery decides to double its production to 200 loaves a day, it experiences increasing returns to scale. The total production cost does not double; instead, it may increase to $350. In this case, the cost per loaf decreases from $2 to $1.75, and the bakery generates more revenue from the additional loaves, resulting in higher profitability (Mankiw & Taylor, 2014).

ii. **Constant Returns to Scale**: In cases of constant returns to scale, a change in production is directly proportional to the change in output or revenue. If production doubles, output and revenue also double. The cost per unit remains constant. Many businesses aim for constant returns to scale as it signifies efficient production (Pindyck, 2017). **Example:** A car manufacturing plant produces 1,000 cars per month at a total monthly cost of $1,000,000. If the plant decides to double its production to 2,000 cars per month, it experiences constant returns to scale. The total production cost doubles to $2,000,000, and the cost per car remains constant at $1,000 (Samuelson & Marks, n.d.).

iii. **Decreasing Returns to Scale**: Decreasing returns to scale occur when an increase in production leads to a proportionally smaller increase in output or revenue. As production scales up, the cost per unit of production rises, and revenue increases at a slower rate. This situation is often observed when a business becomes too large or faces diminishing efficiencies as it expands (Pindyck, 2017). **Example:** A small farm produces 100 bushels of apples per year at a total cost of $10,000. If the farm decides to quadruple its production to 400 bushels of apples per year, it experiences decreasing returns to scale. The total cost more than quadruples to $45,000, resulting in a higher cost per bushel. The farm may face challenges in marketing and selling all the apples, and the additional revenue may not increase as significantly as expected (Besanko & Braeutigam, 2014).

4. The Cobb-Douglas production function

In economics, a production function is an equation that describes the relationship between input and output, or what goes into making a certain product, and a Cobb-Douglas production function is a specific standard equation that is applied to describe how much output two or more inputs into a production process make, with capital and labor being the typical inputs described. Developed by economist Paul Douglas and mathematician Charles Cobb, Cobb-Douglas production functions are commonly used in both macroeconomics and microeconomics models because they have several convenient and realistic properties (Moffatt, 2019).

4.1. Significance of the Cobb-Douglas Production Function:

The Cobb-Douglas production function is highly flexible and can accommodate various combinations of inputs and output. It is not limited to just labor and capital; it can be extended to include other factors of production, making it applicable to a wide range of industries and sectors (Moffatt, 2019).

The Cobb-Douglas production function remains a valuable tool in economics for understanding and modeling production processes, assessing productivity, and making policy recommendations in various industries and economic contexts (Samuelson & Marks, n.d.).

4.2. Advantages:

i. **Simplicity:** The Cobb-Douglas function is mathematically simple and easy to work with. Its linear and multiplicative form simplifies calculations and facilitates economic analysis (Besanko & Braeutigam, 2014).

ii. **Interpretability:** The parameters in the Cobb-Douglas function have straightforward economic interpretations. The coefficients represent the elasticities of the inputs, providing insight into the sensitivity of output to changes in input levels (Besanko & Braeutigam, 2014).

iii. **Constant Returns to Scale: T** he Cobb-Douglas function assumes constant returns to scale. This property is often considered a desirable feature in economic models, as it implies that doubling all inputs will double output, simplifying analysis (Mankiw & Taylor, 2014).

iv. **Flexibility:** While it is typically used to model the relationship between labor and capital and output, the Cobb-Douglas function can be extended to include other factors of production or technology changes, making it adaptable to various industries and situations (Mankiw & Taylor, 2014).

4.3. Limitations:

i. **Homogeneity of Degree One:** The Cobb-Douglas function exhibits homogeneity of degree one, meaning that it assumes all inputs are perfectly substitutable at a constant rate. In reality, input substitution may not be constant, especially in the short term (Besanko & Braeutigam, 2014).

ii. **Constant Returns to Scale Assumption:** While constant returns to scale may be a convenient assumption, it may not always hold in practice. Some industries may experience increasing or decreasing returns to scale due to factors like resource constraints or inefficiencies at different scales of production (Besanko & Braeutigam, 2014).

iii. **Simplistic Input Interactions:** The Cobb-Douglas function assumes a fixed and linear relationship between inputs and output. It may not capture complex interactions or nonlinear relationships that exist in some production processes (Besanko & Braeutigam, 2014).

iv. **Limited Real-World Precision**: The Cobb-Douglas function is a simplification of real-world production processes. While it provides useful insights, it may not capture all the nuances and variations observed in actual industries (Besanko & Braeutigam, 2014).

v. **Data Requirements**: Accurate estimation of Cobb-Douglas production function parameters requires extensive and high-quality data on inputs and outputs, which may not always be available (Besanko & Braeutigam, 2014).

4.4. Opportunity Costs

The economic cost or opportunity cost is the value of the best alternative use of a resource. The opportunity cost includes both explicit and implicit costs. If a firm purchases and uses an input immediately, that input's opportunity cost is the amount the firm pays for it. However, if the firm does not use the input in its production process, its best alternative would be to sell it to someone else at the market price. The concept of an opportunity cost becomes particularly useful when the firm uses an input that is not available for purchase in a market or that it purchased in a market in the past (Perloff, 2018).

4.5. Economic Profits

Economic profit is a measure of a firm's profitability that takes into account both explicit costs (such as wages, rent, and materials) and implicit costs, including the opportunity cost of the owner's time and capital. It is calculated by subtracting all costs (both explicit and implicit) from total revenue (Perloff, 2018).
The formula for economic profit is:

Economic Profit = Total Revenue - Total Opportunity Cost (Explicit + Implicit Costs)

4.6. Differences between Opportunity Costs and Economic Profits:

i. **Nature of the Concept:**

- Opportunity cost is a concept that applies to decision-making in various aspects of life and economics. It represents the value of the next best alternative that is foregone when a choice is made (Besanko & Braeutigam, 2014).
- Economic profit, on the other hand, is a specific financial metric used to assess a firm's profitability by accounting for both explicit and implicit costs. It is often used in business and financial analysis (Besanko & Braeutigam, 2014).

ii. **Measurement:**

- Opportunity costs are subjective and can be challenging to measure precisely, as they depend on individual preferences and circumstances (Mankiw & Taylor, 2014).
- Economic profit is a measurable financial metric that is calculated using explicit and implicit costs and revenues (Mankiw & Taylor, 2014).

iii. **Application:**

- Opportunity costs are used to make decisions by comparing the benefits of different alternatives. They help individuals and businesses assess trade-offs and make choices that maximize their welfare (Besanko & Braeutigam, 2014).
- Economic profit is primarily used in financial analysis to evaluate the performance of a business. It provides insights into whether a business is generating returns that exceed both its explicit and implicit costs (Besanko & Braeutigam, 2014).

4.7. Practical Example of Opportunity Costs in a Business Context

Imagine a small manufacturing company that produces two types of products: Product A and Product B. The company has limited resources, including labor and machinery, and can only produce one product at a time due to capacity constraints. The market demand for both products is strong, and each product generates a similar profit margin (Brigham & Houston, 2018).

i. **Scenario 1: Producing Product A**

- If the company decides to produce Product A, it can sell it for a profit of $10,000.
- However, by choosing to produce Product A, the company foregoes the opportunity to produce Product B, which could have been sold for a profit of $8,000.

ii. **Scenario 2: Producing Product B**

- Conversely, if the company chooses to produce Product B, it can sell it for a profit of $8,000.
- In this case, by selecting Product B, the company misses out on the opportunity to produce Product A, which could have been sold for a profit of $10,000.

In this example, the opportunity cost of producing Product A is the profit of $8,000 that the company gives up by not producing Product B, and vice versa. The decision-making process involves weighing these opportunity costs against each other to determine which product to produce based on maximizing overall profitability (Brigham & Houston, 2018).

4.8. Fixed Costs and Sunk Costs:

4.8.1. Fixed Costs: Fixed costs are expenses that do not vary with the level of production or output. They remain constant regardless of whether a company produces one unit or one million units of a product. Fixed costs are incurred to maintain the business's basic operations and are typically associated with the company's physical facilities and infrastructure. Examples of fixed costs include rent or lease payments for facilities, insurance premiums, salaries of permanent staff, and depreciation of assets. Fixed costs must be paid to keep the business running, but they do not change with changes in production levels. In cost analysis, they are considered when calculating the break-even point, which helps determine the minimum level of sales required to cover all costs (Mankiw & Taylor, 2014).

4.8.2. Sunk Costs: Sunk costs are costs that have already been incurred and cannot be recovered, regardless of the future decisions made by the company. They are expenditures that are "sunk" because the money spent on them is gone and cannot be reclaimed. Sunk costs should not influence future decision-making because they are irrelevant to the choice at hand. An important principle related to sunk costs is the concept of "sunk cost fallacy." This fallacy occurs when decision-makers consider the amount of money already spent when making decisions about the future. The rational approach is to focus on prospective costs and benefits rather than past expenditures that cannot be changed (Mankiw & Taylor, 2014).

4.9. Distinction Between Fixed Costs and Sunk Costs:

The key distinction between fixed costs and sunk costs lies in their nature and relevance to decision-making (Mankiw & Taylor, 2014):

i. **Nature:**
- **Fixed Costs:** Fixed costs are ongoing, necessary expenses that a company incurs to operate its business and do not change with changes in production or output.
- **Sunk Costs:** Sunk costs are historical costs that have already been spent and cannot be recovered, regardless of future decisions.

ii. **Relevance to Decision-Making:**
- **Fixed Costs:** Fixed costs are relevant to decision-making in the short run because they must be covered to maintain ongoing operations. They are considered when calculating break-even points and assessing short-term profitability.
- **Sunk Costs:** Sunk costs are not relevant to decision-making because they cannot be changed or recovered. Decisions should be based on prospective costs and benefits, and sunk costs should not influence choices.

iii. Why Are Sunk Costs Important?

Sunk costs are important because may act as distractors in decision-making. When a company analyzes costs and benefits, sunk costs should have no bearing on the decision-making process as the sunk cost will be incurred regardless of the outcome of the choice. Sunk costs are important to be mindful of because incorrectly including them in an analysis may lead to a less favorable decision being chosen (Tuovila, 2023).

4.10. Real-World Examples of Fixed Costs in a Business Setting

i. **Rent:** A retail store pays a fixed monthly rent to lease its physical space. Regardless of whether the store makes many sales or few sales in a given month, the rent remains the same (Horngren and others, 2018).

ii. **Salaries:** A company pays fixed monthly salaries to its full-time employees, such as managers and administrative staff. These salaries do not vary with changes in production or sales (Horngren and others, 2018).

iii. **Depreciation:** A manufacturing plant incurs fixed depreciation costs on its equipment and machinery. These costs remain unchanged regardless of the level of production (Horngren and others, 2018).

4.11. Real-World Examples of Sunk Costs in a Business Setting:

i. **Research and Development (R&D) Expenses:** A pharmaceutical company invests heavily in researching and developing a new drug. After several years and significant expenses, it becomes clear that the drug is not viable due to regulatory issues. The R&D expenses incurred are considered sunk costs (Horngren and others, 2018).

ii. **Advertising Expenditures:** A tech startup spends a substantial amount on advertising campaigns to promote its new app. However, after launching the app, it fails to gain traction in the market. The money spent on advertising is a sunk cost (Horngren and others, 2018).

iii. **Training Costs:** A company sends its employees for extensive training to implement a new software system. After the training, the company decided not to proceed with the software implementation due to compatibility issues. The training costs are considered sunk (Horngren and others, 2018).

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