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The Upshot

Who Will Lead the Senate? Follow the Prediction Markets

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Economic View

By JUSTIN WOLFERS

How would commentary on the midterm election look if economists, rather than Beltway pundits, were calling the race? You would read a lot less about personalities, gaffes and gossip, and a lot more about fundamentals like the state of the economy. And you would certainly get a more sophisticated reading of polls and political prediction markets.

Let's start with the fundamentals, which shape what is possible. Given the near certainty that control of the House of Representatives won't change, I'll focus on the Senate, where Republicans need to pick up six extra seats to take control.

There's a lot of upside for Republicans in this election cycle, and very little downside, as eight Democrats are defending winning margins from the last election of 10 points or less. Mitch McConnell, the Senate minority leader, is the only Republican in this perilous position.

In addition, midterm elections typically spell bad news for the party in control of the White House. Ever since World War II, the president's party has, on average, lost a net four Senate seats in midterm races.

Incumbency also matters, and careful studies suggest that senators running for re-election effectively begin with a head start of 8 to 10 percentage points. As a result, around 90 percent of incumbent senators are re-elected. Turnover is much more likely in open seats, and the Democrats find themselves defending five seats previously occupied by retiring Democrats, three of which are in states that voted for Mitt Romney in 2012. And while three Republican senators are retiring, they are all in Republican-leaning states.

These fundamentals add up to a powerful structural advantage for Senate Republicans. They also yield the sort of predictive power that economists often only dream about. But to a pundit, they may present a quandary: The broad contours of the election were largely set in stone nearly two years ago, yet column inches still need to be filled for a narrative-hungry readership. No surprise, then, that the supply of dramatic political narrative rises to meet the demand, and the commentariat largely ignores the underlying predictability of most elections.

The one fundamental force that has changed over the past two years — sharply — is the state of the economy. This should be a major positive for Democrats, as improving economic conditions generally lead to better results for the president's party. Even as the unemployment rate remains somewhat elevated, it has fallen by more during this two-year congressional term than in any previous midterm election cycle in the postwar era.

Indeed, the unemployment rate has fallen exactly 4.1 percentage points since its double-digit recessionary peak, which exactly matches the peak-to-trough decline that Ronald Reagan presided over at a similar point in his presidency.

In many respects, the economy remains in bad shape. Yet this is beside the point, as voters tend to respond to changes in economic conditions — the extent to which the economy has improved — rather than its current level. This distinction helps explain how President Obama won re-election in 2012, in the face of a very weak (though rapidly improving) economy.

To be sure, there's debate about how much the economy has improved. Even as unemployment has fallen, the proportion of the population with a job has barely risen, gross domestic product is merely puttering along, and wages are barely rising for most workers.

Of course, these economic fundamentals matter only to the extent that they affect voters, which raises the question of how best to make sense of polls. The basic rules for interpreting economic statistics also apply to polling data: Big samples beat small samples, and a dashboard of indicators is more convincing than any single survey, which is why it's important to aggregate information from many pollsters.

Importantly, campaign events often drive sharp shifts in sentiment, although these effects are typically short-lived. A result is that polls often fluctuate wildly even as electoral fortunes evolve slowly. But as Election Day approaches, polls tend to shift toward the fundamentals, as economic and political realities come into sharper focus. There's no point being steered in the wrong direction by polls that will later reverse themselves, which is why careful poll analysis — like that used by The Upshot's model, which we've nicknamed Leo — filters polling data through a lens that takes account of the underlying fundamentals. By now, Leo suggests that the Republicans have a 66 percent chance of taking control of the Senate.

While Leo and other poll-aggregation models are built to reflect the results of surveys asking people whom they intend to vote for, my research with David Rothschild of Microsoft Research suggests that asking people who they think will win typically yields even more accurate forecasts. A recent survey by Gallup (where, full disclosure, I do consulting as a senior scientist) found that 52 percent of people expect Republicans to win control of the Senate, compared with 42 percent who expect the Democrats to win. While a majority expect a Republican victory, the differential is smaller than that seen in the Obama-versus-Romney race, suggesting only a modest Republican edge.

How should you combine insights from the basic political factors — the state of the economy, opinion polls and voter expectations? Economics doesn't provide a formula, but rather a suggestion: Turn to political prediction markets where people trade securities linked to election outcomes. When many people make trades based on their individual perspectives, the price comes to reflect each of the most relevant factors, effectively weighting each by the confidence that traders have in them.

While the Intrade market, once popular, is no longer with us, the idea lives on at Betfair, a prediction market run in Britain. As I'm writing, you can buy a security, which pays $100 if the Republicans take control of the Senate, at a discount: The security is going for around $69, which suggests a 69 percent chance that this will happen. Offshore bookmakers are offering similar odds.

Even though markets are prone to their own failures, they have amassed a better record of accuracy than even the most sophisticated models that are based on fundamentals and polling. The point is that while markets aren't perfect, in practice they're less imperfect than the other election forecasters.

This economist's bottom line, then, is that there's a 69 percent chance that Republicans will win the Senate. This forecast is clear, it's precise, it's quantitative (in that it acknowledges and specifies uncertainty), and it's easily evaluated. In other words, it's terrible punditry, but good economics. And, if you think it's wrong, you can bet against it.

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