

December 31, 2007

Best Bet for Next President: Prediction Markets

A Wharton economist argues prediction markets can cut through the clutter of polls and pundits.

By JUSTIN WOLFERS
 December 31, 2007

As the 2008 presidential race heats up, voters are overwhelmed by a flood of new data: Who is ahead in the polls? Who is winning the "money race"? How are the dynamics of the race likely to respond as the candidates tack left and right, advertising strategies change, and we learn whose Web site is drawing more eyeballs?

Political prediction markets provide us -- the consumers of this information -- with a way to cut through this clutter.

A prediction market is a bit like the stock market, except that you are buying shares whose value depends on the success of a political candidate, rather than the profits earned by a corporation. And just as stock prices are a useful barometer of the health of a company, so too the price of a prediction contract is a barometer of the health of a political campaign.

BEST BETS

NOTE: Wagering on political or other events is illegal in some jurisdictions.

• [The Wall Street Journal's Political Prediction](#)

[Market](#)¹: Our own free, play-money political prediction market.

• [The Iowa Electronic Market](#)²: Established in 1988 by academics at the University of Iowa, this small-stakes (<\$500) prediction market is the longest running among those listed here.

• [Real Time Economics](#)³: Economic insight and analysis from the Journal.

• [InTrade](#)⁴: A wide-ranging prediction market run from Ireland. InTrade tends to have the largest array of intriguing real-money prediction markets.

• [BetFair](#)⁵: A UK-based competitor to InTrade.com. BetFair is the world's largest betting exchange, but does not take bets from Americans.

• [PaddyPower](#)⁶ is an online sportsbook that offers a wide array of interesting and fun "novelty bets" (including politics).

Alternatively, for those schooled on the Strip rather than the Street, prediction markets allow you to bet on the election, just as Vegas bookies allow you to bet on a football game. And the uncanny ability of the betting line to predict football outcomes also holds in the political domain.

It is the accuracy of market-generated forecasts that led the Department of Defense to propose running prediction markets on geopolitical events. While political rhetoric about "terrorism futures" led the plug to be pulled on that particular experiment, the original insight -- that markets can help make sense of vast amounts of disparate information--remains valid.

Experimental prediction markets were established at the University of Iowa in 1988, and they have since amassed a very impressive record, repeatedly outperforming the polls. Research by economic historians has documented betting on elections over a century ago, and the impressive forecasting record of prediction markets was also evident in the period before scientific polling was adopted.

More recently, in the 2004 primaries, prediction markets pointed to the disintegration of Howard Dean's candidacy in advance of the fateful Iowa caucuses. In the 2004

presidential election, the market favorite won the Electoral College in all fifty states; in 2006 the markets also picked every Senate race.

How do these markets work? Right now, you can buy a \$1 bill for 44 cents; the only catch is that you only get the \$1 if Hillary Clinton is our next President. The fact that this \$1 bill is selling for 44 cents tells us that "the market" believes her to have a 44% chance of winning the presidency, a number that has risen sharply as she has become more likely to win the Democratic nomination. Interestingly, prediction markets have long suggested a strong showing for Ms. Clinton, even as popular commentators had earlier dismissed her as unelectable, much as they did prior to her successful New York senate race in 2000.

In a truly efficient prediction market, the price will come to reflect the influence of all available information. For instance, those discouraged by Ms. Clinton's recent polling in New Hampshire are probably selling, while those who believe endorsements by the Iowa Register are crucial are buying; Ms. Clinton's campaign to increase her likeability may lead some to buy, while recent mis-steps by her campaign may lead others to sell. Economists influenced by the possibility of a recession are buying various Democrats, while political scientists schooled in the incumbency advantage are probably buying Republicans.

Through this process of different people trading based on their own observations about

DOW JONES REPRINTS

 This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Order Reprints tool at the bottom of any article or visit: www.djreprints.com.

- [See a sample reprint in PDF format.](#)
- [Order a reprint of this article now.](#)

WISDOM OF CROWDS

To learn more about uses of political prediction markets, see:

- ["Pricing Political Risks with Prediction Markets,"](#)⁷ by Justin Wolfers.
- A more in-depth treatment, including discussion of how prediction markets have been used by corporations, policymakers, and in finance, is available in the paper ["Prediction Markets,"](#)⁸ by Justin Wolfers and Eric Zitzewitz.
- A broader analysis of information aggregation is available in James Surowiecki's bestseller, ["The Wisdom of Crowds,"](#)⁹
- A comprehensive analysis of the prediction markets run by the University of Iowa is available in ["Results from a Dozen Years of Election Futures Markets Research"](#)¹⁰, by Joyce Berg, Robert Forsythe, Forrest Nelson and Thomas Rietz.
- An intriguing survey of political prediction markets over the past century is available in the research

the race, prediction markets prices come to aggregate disparate pieces of information into a single summary measure of the likelihood of various outcomes. Moreover, if this market operates efficiently, it will appropriately summarize all of this information and the price will become the most statistically accurate forecast of the election outcome.

study "Historical Presidential Betting Markets¹¹," by Paul Rhode and Koleman Strumpf.

Two other characteristics also distinguish prediction markets. First, they respond to all sorts of news beyond shifts in public opinion, including changes in campaign staff, political re-positioning, and performance on the trail.

Second, prediction markets are forward-looking, while polls are often backward-looking. For instance, Fred Thompson continues to do well in national polls largely due to name recognition, while prediction markets have discounted this advantage, understanding that candidates like Mike Huckabee will become better known through the campaign. Indeed the markets currently believe that Mr. Thompson is less likely to win the Republican nomination than fringe candidate Ron Paul.

Beyond Mr. Thompson, polling data for Republican candidates is much more consistent with the markets, suggesting a four-way race in which Messrs. Giuliani and Romney are the leading candidates, with Messrs. McCain and Huckabee not too far behind. The markets predicted Mr. Huckabee's surge a few weeks before the polls, and it appears to have come at the expense of Mr. Romney. The big story this week, though, is John McCain, who has resurrected his campaign. The market now judges him to be a clearly credible alternative.

On the Democratic side, national polls suggest a landslide for Ms. Clinton, while the markets suggest that the race is still very competitive, with a one-in-three chance that Obama or Edwards will ultimately win the nomination.

Turning to the general election, the markets are titling strongly pro-Democratic, ranking them a 61% chance of taking the White House.

Stay tuned during the campaign, and we'll continue to track where the markets undermine the conventional wisdom, and when they start to point to barely emergent trends. I can't predict what these trends will be, but I'll bet that the markets will yield interesting insights. I will highlight them for you in the coming weeks.

Justin Wolfers is an Assistant Professor of Business and Public Policy at the University of Pennsylvania's Wharton School. He will be writing for the Journal about the 2008 presidential campaign through the prism of prediction markets. You can reach him at predictions@wsj.com¹².

URL for this article:

<http://online.wsj.com/article/SB119902559340658043.html>

Hyperlinks in this Article:

- (1) JAVASCRIPT:OpenWin('http://predictions.wsj.com',,,,,'na+me+lo+sc+',true,0,0,true);void("")
- (2) JAVASCRIPT:OpenWin('http://www.biz.uiowa.edu/iem',,,,,'na+me+lo+sc+',true,0,0,true);void("")
- (3) <http://online.wsj.com/economics/>
- (4) JAVASCRIPT:OpenWin('http://www.intrade.com',,,,,'na+me+lo+sc+',true,0,0,true);void("")
- (5) JAVASCRIPT:OpenWin('http://www.betfair.com',,,,,'na+me+lo+sc+',true,0,0,true);void("")
- (6) JAVASCRIPT:OpenWin('http://www.paddypower.com/bet?action=go_category&category=SPECIALS',,,,,'na+me+lo+sc+',true,0,0,true);void("")
- (7) JAVASCRIPT:OpenWin('http://siepr.stanford.edu/papers/briefs/policybrief_jun04.pdf',,,,,'me+lo+',true,0,0,true);void("")
- (8) JAVASCRIPT:OpenWin('http://bpp.wharton.upenn.edu/jwolfers/Papers/Predictionmarkets.pdf',,,,,'me+lo+',true,0,0,true);void("")
- (9) JAVASCRIPT:OpenWin('http://www.randomhouse.com/features/wisdomofcrowds',,,,,'me+sc+',true,0,0,true);void("")
- (10) JAVASCRIPT:OpenWin('http://www.biz.uiowa.edu/iem/archive/BFNR_2000.pdf',,,,,'me+lo+sc+',true,0,0,true);void("")
- (11) JAVASCRIPT:OpenWin('http://www.unc.edu/~cigar/papers/BettingPaper_final(JEP_Resubmit).pdf',,,,,'me+lo+sc+',true,0,0,true);void("")
- (12) <mailto:predictions@wsj.com>

Copyright 2007 Dow Jones & Company, Inc. All Rights Reserved

This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our [Subscriber Agreement](#) and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit www.djreprints.com.

RELATED ARTICLES AND BLOGS

Related Content may require a subscription | [Subscribe Now -- Get 2 Weeks FREE](#)

Related Articles from the Online Journal

- [Marty Lipton's Pricey M&A Advice \(But Free Predictions\)](#)
- ['Nimble' Monetary Policy Is Needed, Fed's Kohn Says](#)
- [Economy Moves To Fore as Issue For 2008 Voters](#)
- [Ericsson Suspected of Breaking Rules](#)

Blog Posts About This Topic

- [Prediction Markets](#) ryanavent.com
- [Money Meet Mouth](#) matthewyglesias.com

[More related content](#)

Powered by Sphere 