

June 12, 2008

POLITICAL EXCHANGE

Decoding the Prediction Markets

By DAVID STRÖMBERG and JUSTIN WOLFERS

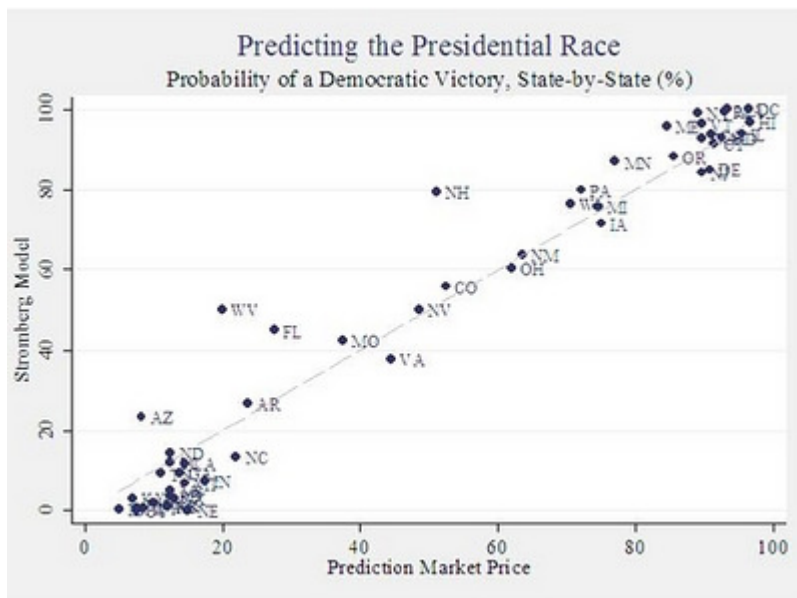
June 12, 2008

Political prediction markets give the Democrats a 63% chance¹ of winning the White House in November. But the markets won't give even the slightest hint as to the sources of this pronounced Democratic edge.

I have argued in previous columns² that prediction markets provide the single best forecast of election outcomes. But these markets, such as the WSJ's Political Market³ powered by Intrade, can be frustratingly savant-like. While they spit out useful bottom lines, prediction markets don't provide the sort of narrative necessary to understand the forces behind the forecasts.


To help pinpoint what might be moving these markets, we've crunched the numbers from David Strömberg's econometric model for forecasting election outcomes. The results are remarkably consistent with the prediction markets, suggesting a 65% chance that Sen. Obama beats Sen. McCain.

The Strömberg model is quite unique because it yields predictions of the likelihood that each candidate will win each state. The figure below shows that, even in a state-by-state breakdown, the data-driven forecast is remarkably similar to the political prediction market⁴.



Given these consistent conclusions, it stands to reason that prediction markets are likely weighing the same factors used in the Strömberg model, such as opinion polls, the ideology of the electorate and local economic conditions. The model also accounts for political factors, including measures of each party's

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.

success in recent state-level elections. Understanding that no state is an island (sorry, Hawaii), we also account for the influence of similar national factors. (Interested readers can get the full model details [here](#)⁵.)

Taken together, these factors suggest that the Democrats are likely to win 51% of the popular vote, and to win the Electoral College 294-244.

In turn, this Democratic edge reflects the combination of a weak economy and incumbency effects in the wake of the unpopular Bush presidency, which are likely to disadvantage Sen. McCain. Weak local conditions and liberal swings in the electorate suggest that Democrats are likely to do well in key states like [Ohio](#)⁶, [Pennsylvania](#)⁷ and [Michigan](#)⁸. Prediction markets are less bullish about the Democrats' chances in [Florida](#)⁹.

For all the attention paid by pundits to opinion polls, our analysis suggests that, at this point in the election cycle, they simply aren't very informative. As such, we give them very little weight. But as the election gets closer, polls become more predictive and will warrant greater weight.

Our quantitative model excludes those themes that have dominated recent media coverage: the personalities, age, race and gender of the candidates, as well as their former preachers and possible VP candidates. Vague concepts like "electability" don't figure into the equation.

Even so, the model matches prediction market prices, suggesting that markets are more informed more by economic and political fundamentals than broader campaign narratives. (This is not to say that personalities don't matter; it may be that we are yet to learn much about how the electorate will respond to the candidates.)

The most important factor highlighted by our analysis is simply the substantial uncertainty about the likely outcome in November. It is this uncertainty that leads us to suggest a strong Democratic performance, while still allowing for a [36% chance of a Republican victory](#)¹⁰.

Alternatively phrased: Sen. Obama's lead is real, but shaky.

The Strömberg model also suggests that there is a one-in-four chance that the 2008 race will come down to the decisions of a less than one-in-100 voters in just one state -- a situation that would be similar to Florida in 2000 or Ohio in 2004.

Which states are likely to be decisive? Our list of battleground states are headed by the usual suspects, but campaign strategists take note: Beyond the big four, a few surprises emerge. Colorado, Virginia and California are next-most likely to determine the election.

You might be surprised to see strongly Democratic California on that list, but we really can't be certain which way Golden State voters will tilt (Governor Schwarzenegger, anyone?). Even though California has only a [9% chance to tip Republican](#)¹¹, that outcome would almost certainly deliver the White House.

Stay tuned: As new data come in, we will continue both to update the econometric forecasting model and track the race through the lens of prediction markets.

The authors are, respectively, Associate Professor of Economics at Stockholm University, and Assistant Professor of Business and Public Policy at the University of Pennsylvania's Wharton School. Write to Mr. Wolfers at predict@wsj.com¹².

URL for this article:

<http://online.wsj.com/article/SB121323408719266705.html>

Hyperlinks in this Article:

- (1) <http://predictions.wsj.com/aav2/trading/contractInfo.jsp? conDetailID=68264&z=1212583956256>
- (2) <http://online.wsj.com/article/SB119902559340658043.html>
- (3) <http://predictions.wsj.com/>
- (4) <http://predictions.wsj.com/aav2/trading/tradingHTML.jsp? evID=7668&eventSelect=7668&updateList=true&showExpired=false>
- (5) <http://www.iies.su.se/~stromber/ElectoralCollege.pdf>
- (6) <http://predictions.wsj.com/aav2/trading/contractInfo.jsp? conDetailID=68385&z=1212151460277>
- (7) <http://predictions.wsj.com/aav2/trading/contractInfo.jsp? conDetailID=68394&z=1212151472476>
- (8) <http://predictions.wsj.com/aav2/trading/contractInfo.jsp? conDetailID=68346&z=1212151488813>
- (9) <http://predictions.wsj.com/aav2/trading/contractInfo.jsp? conDetailID=68307&z=1212139076818>
- (10) <http://predictions.wsj.com/aav2/trading/contractInfo.jsp? conDetailID=68265&z=1212584093048>
- (11) <http://predictions.wsj.com/aav2/trading/contractInfo.jsp? conDetailID=68293&z=1212151958630>
- (12) <mailto:predict@wsj.com>

Copyright 2008 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 FROM ACROSS THE WEB

[More related content](#)

Powered by [Sphere](#) 