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POLITICAL EXCHANGE

Decoding the Prediction Markets

By DAVID STRÖMBERG and JUSTIN WOLFERS

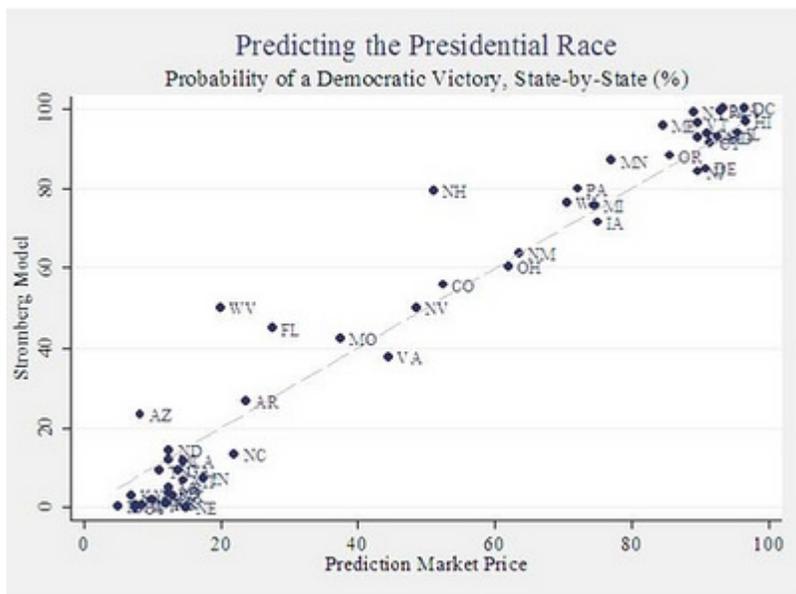
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Political prediction markets give the **Democrats a 63% chance**¹ of winning the White House in November. But the markets won't give even the slightest hint as to the sources of this pronounced Democratic edge.

I have argued **in previous columns**² that prediction markets provide the single best forecast of election outcomes. But these markets, such as the **WSJ's Political Market**³ 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 candidates 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 market**⁴.



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

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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.

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