The Economist

Election forecasting

Prediction 2016

How Jesse Jackson inadvertently revived political betting

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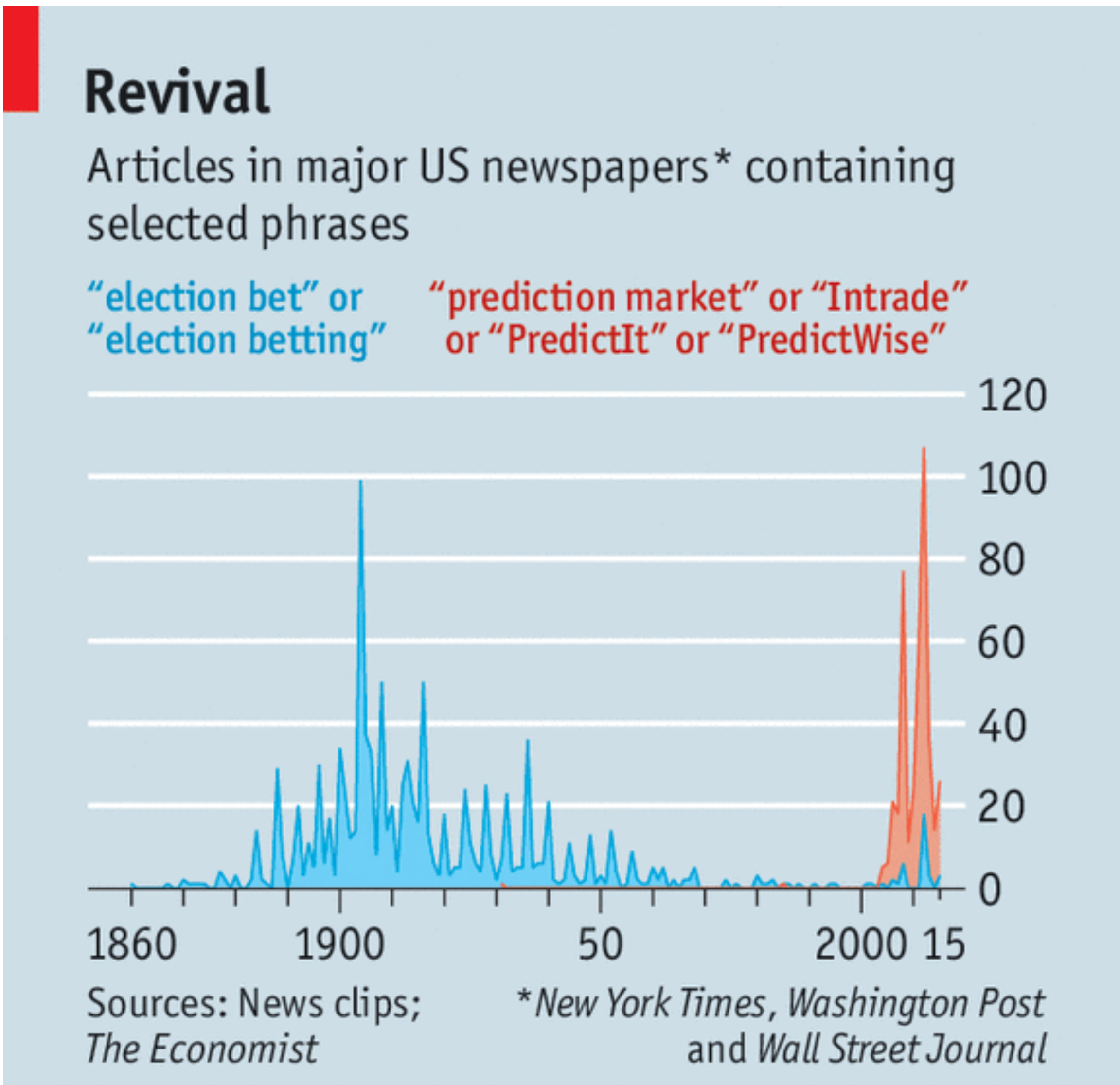

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YOU believed the pollsters, America's 2012 presidential election looked like a nail-biter. Most national surveys had Mitt Romney and Barack Obama tied; Gallup, the country's oldest scientific polling outfit, had the challenger ahead, 49% to 48%. When the votes were counted, however, Mr Obama won by four percentage points. To many political pundits, as to Mr Romney, Mr Obama's margin of victory came as a shock. Among bettors, however, it barely elicited a shrug: prediction markets, in which punters wager on the outcomes of elections, had always considered the incumbent a heavy favourite. An Irish bookmaker, Paddy Power, was so confident of his chances that it paid out £400,000 ($640,000) two days before the election to people who had bet on Mr Obama. Will this trick be repeated in 2016?

Though now a fringe asset class, prediction markets are in fact among the oldest exchanges in America. In the 1820s prominent supporters of candidates frequently offered public wagers on them as a demonstration of their conviction. Punters who could not afford to pony up cash would compensate with offers of public humiliation: one common wager made losers trundle winners around in a wheelbarrow; another required them to roll peanuts up and down streets with toothpicks. Some losers had to eat real crow.

Half a century later, these expressions of bravado had evolved into semi-formal financial markets. Trading volume began to approach that of actual shares: in 1916 $10m ($218m in today's prices) was wagered on the photo-finish race between Woodrow Wilson and Charles Hughes. The markets were wrong that year, predicting a win for Hughes. But in 11 of 12 elections between 1884 and 1940 when bettors had identified a clear favourite by mid-October they were vindicated, despite operating in an era without any reliable polling. Newspapers diligently reported presidential betting odds: according to Paul Rhode and Koleman Strumpf, the economists who unearthed the records of these markets, the press published prices five days a week in the month before an election.

The death knell for the electoral markets of yesteryear sounded in 1936, when George Gallup of the American Institute of Public Opinion stationed pollsters on street corners and asked passers-by whom they would vote for, thus obtaining a random sample. The well-known *Literary Digest* survey, which relied on readers mailing in postcards, had over-sampled the well-off and called the election for the Republican Alf Landon, while Gallup accurately predicted an easy victory for the incumbent, Franklin Roosevelt. Punters were not fooled by the *Digest*'s "poll", and also forecast that Roosevelt would win. But the dawn of scientific polling made gambling odds look amateurish, and allowed newspapers to publish campaign updates without having to cite markets of dubious legality and (in their view) morality.

Nonetheless, the markets might have soldiered on had history not conspired against them.

The industry was centred in New York, and during the second world war Fiorello La Guardia, the city's mayor, launched a crackdown on unauthorised gambling. His raids drove political bookmakers deep underground or out of town. At the same time, competing forms of wagering began to offer alluring substitutes. In 1939 the state legalised betting on horse races, allowing punters to slake their thirst for action dozens of times a day rather than once every four years, without any risk that a bookie would fail to pay out.

By the late 1940s, what was once an eight-figure marketplace had all but vanished. Electoral betting would not make a comeback until 1988, when Jesse Jackson defied expectations to win Michigan's Democratic presidential primary. His victory highlighted how unreliable polls could be, and led a group of professors at the University of Iowa to hunt for an alternative. Though unaware of prediction markets' pre-war history, they reinvented the idea by setting up an "Iowa Political Stock Market", in which students and faculty could wager modest sums on the upcoming general election. Four years later, America's Commodity Futures Trading Commission (CFTC) authorised the Iowa Electronic Markets to take money from the public because they were at heart an academic enterprise, though the regulators capped bets at $500 to prevent speculation with meaningful sums.

For the next 20 years the IEM consistently out-performed polls in various executive, legislative, national and local elections in a dozen different countries. But the logistical difficulty of placing bets on the exchange (particularly before internet access became widespread), along with the low wagering ceiling, limited it to trivial volumes of a few hundred thousand dollars a year. It was not until 2008, after the internet had globalised both information and financial flows, that pre-war prediction markets found a worthy heir.

During the 2004 presidential campaign an Irish sports-betting site called Intrade started taking bets without the low limits of the IEM. Even though credit-card companies in America would not process deposits to the site, punters flocked to it. A whopping $230m was wagered on the 2012 election—an even greater sum in constant dollars than on the Hughes-Wilson contest of 1916. And like its predecessors, Intrade was deadly accurate. Its markets correctly predicted the results of 47 of the 50 states in the election of 2008, and 49 of 50 in 2012.

But just like the street-corner action of the 1930s, Intrade soon came under legal scrutiny. In November 2012 the CFTC ordered the site to stop offering contracts on the price of goods under the agency's oversight, such as oil and gold. Four months later, the risks of investing in Intrade's unregulated marketplace were laid bare when the site abruptly shut down after it dipped into its clients' funds to transfer money to its late founder. It took months for account-holders to be made whole. The site's untimely demise provided fresh ammunition for those who regard prediction markets as unsavoury speculation.

The collapse of Intrade did not annihilate prediction markets, though. The IEM is alive and well, and in late 2014 PredictIt, an online exchange sponsored by Victoria University of Wellington in New Zealand, entered the fray with an $850 wager cap and official authorisation from the CFTC. But these operations still fall far short of realising prediction markets' full potential. Their low betting limits prevent investors with extremely valuable information—say, a looming scandal—from cashing in on the value of their knowledge and incorporating it into the market price.

At the time of writing, PredictIt reckons that the fight for the Republican nomination is between Ted Cruz and Marco Rubio, and that Hillary Clinton has a 54% chance of becoming the next president.

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