

Predicting the Future of Politics

Forget polls. Politicians and policymakers could soon turn to "prediction markets" to take the nation's pulse—and plan their next move.

WEB EXCLUSIVE

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Nov. 6, 2006 - What could Tom Patrick possibly have to do with the future of politics? He is 49 years old. He once won a national bridge tournament. He lives in Yekaterinburg, the fifth-largest city in Russia. To his west are the Ural Mountains; to his east is Siberia. His business card says "commodities trader," but right now he is "between jobs." Which means that the first thing he does each morning is fire up his 128K-modem and steer one of his five computers (three desktops, one laptop, one HP iPaq handheld) to the just-launched Washington Stock Exchange.

For much of the rest of the day, Patrick, an avowed political junkie with undergraduate degrees in psychology and math and an MBA from the University of Chicago, will "trade" on the WSX (thewsx.com). He will buy shares of a stock called "George Allen (R) to Win VA Senate Seat." He will sell "Barack Obama (D) Announces '08 Campaign." And when all is said and done—at 2 a.m. in Yekaterinburg, when the U.S. business day is ending—he will have pocketed a substantial sum of "money." (Internet gambling is illegal on U.S.-based sites, so the exchange deals in play money, which it calls Washington dollars.) Patrick—or 20010101, his *nom d'écran*—currently tops the WSX's list of most profitable players. His take: W\$45 million. His closest rival trails by W\$31 million. "I'm doing this every waking hour," he says. "Much to my wife's chagrin."

On the eve of this year's crucial and contentious midterm elections, prediction markets like the WSX are packed with Tom Patricks. For such traders, if not their spouses, the WSX is merely a game. But a growing chorus of experts believe that the site and others like it have the potential to revolutionize how we take America's political pulse—a revolution that could, in turn, affect how politicians and policymakers make decisions. "Prediction markets are becoming a standard part of the political discourse," says Justin Wolfers, a markets specialist at the University of Pennsylvania's Wharton School. "They're tremendously exciting."

From Patrick's perspective, such markets are simple enough. He logs on. He checks his net worth. He buys and sells shares in future political events, using information and intuition to predict whether those events will come to pass. But it's only when thousands of traders like Patrick start placing bets that things get interesting. While each individual may not know much, collectively they know a lot. The market aggregates this knowledge, then reflects it, in real time, in the form of prices. Right now, "George Allen (R) to Win VA Senate Seat" is trading at W\$40.13 on the WSX, giving Allen a 40.13 percent chance of winning on Nov 7.

Chances are, those odds are on target: prediction markets have proven to be surprisingly accurate. Much more so, in fact, than polls. The oldest political prediction market has forecasted, on average, presidential vote shares within 1.5 percentage points of the actual outcome, besting traditional surveys by a full point. Overall, markets have outperformed polls in recent elections three-quarters of the time. So even though the major national surveys show Allen and opponent Jim Webb stuck in a statistical dead heat, the smart money is on Webb—and the WSX.

The driving force behind the WSX—betting on election outcomes—is nothing new. Even though the first organized markets didn't materialize until after Abraham Lincoln took office, Americans have wagered on politics since Washington's day. By the early 20th century, political betting at New York's Curb Exchange, complete with frenzied crowds and brokers barking out bid-and-ask odds, often exceeded trading in stocks and bonds, with traders investing a record \$165 million in real dollars during the 1916 presidential contest. "The old axiom in the financial district," wrote The New York Times in 1924, "[is] that Wall Street betting odds are 'never wrong'." In 1936, however, a new-fangled "scientific" poll (designed by some guy named George Gallup) correctly predicted the outcome of the presidential election. The public was smitten.

To this day, our obsession with polls is undiminished—but prediction markets have clawed their way back. First came the small-sums Iowa Electronic Market (IEM), founded in 1988 and run by the College of Business at the University of Iowa. Sites like InTrade, NewsFutures and the Hollywood Stock Exchange soon followed. Now prediction market success stories pop up in the papers every election season, and poll-tracking sites like RealClearPolitics post up-to-the-minute market forecasts.

The WSX arrives, however, at a turning point in the history of the medium. Over the past few years, smart folks have started to recognize that "the wisdom of crowds" reflected in the market can actually help them make wiser decisions. Until recently, these sites served as hubs for research (IEM) and entertainment (the U.K.-based InTrade, where you can bet real money). But they've performed so well at prediction that companies like Google, Microsoft, Yahoo and General Electric have launched in-house versions designed to let employees bet on key questions, like future sales or potential product launch dates. All told, at least two-dozen companies, according to a recent story in BusinessWeek, have shifted some of the burden of prediction from high-priced "expert" executives to the guys on the shop floor. "Nowadays, real firms in the real world are looking to markets to help them make tough calls," says Wolfers, who advises NewsFutures and the WSX. "Markets work."

The WSX is simply the first prediction-market company to realize that politics is nothing but another industry—and that Democrats and Republicans are clients in waiting. "That's really why we built the exchange," says founder David Perry, who's also the president of Consensus Point, Inc., a Nashville-based software and consulting company that has sold its prediction-market engine to GE, Best Buy and Samsung. "We wanted to create a database of intelligence about the future of politics so that we can help political parties and individual candidates make better policy decisions."

Perry claims that he's currently in touch with Congressional staffers and senior members of opinion research organizations who are frustrated with the inefficiency and inaccuracy of modern polling. (He declined to give names.) He says they've expressed interest in paying to pose particular questions—Will Missourians vote for a ban on embryonic stem-cell research?—to the WSX's most accurate traders. (Caller ID and cell phones have made it increasingly difficult for pollsters to round up large, representative samples of the electorate; the WSX only needs 100 Tom Patricks to work.) "Right now, there are limited tools for predicting legislative or regulatory outcomes other than gut instinct," says Arik Ben-Zvi, senior vice president of the Glover Park Group, a powerful D.C. consulting firm. "Say two major companies are merging. We'd want to ask the WSX if the Justice Department will approve the merger. That predictive power is very important—to companies, to investors and to policy folks. And it could be applied to almost anything."

Still, Perry's exchange is young, and potential pitfalls await. Without monetary incentives, prices can fluctuate wildly (though they remain just as accurate, on average, as in a real-money market). Attempts to manipulate stock prices—unsuccessful so far—will intensify if Washington gets involved and raises the site's profile. And wagering on the likelihood of, say, a terrorist attack is enough to make most politicians squirm. (Just ask DARPA, the U.S. Defense Department agency which in 2003 developed a program to project geopolitical risks that was quickly labeled a "terrorism futures market" and shuttered amid bipartisan furor.) But Perry is optimistic. "You've got a lot of political junkies out there who live on this site because they want to demonstrate their political prowess," he says. "But at the same time, they're creating accurate intelligence about future events. This is the next generation of politics." Ladies and gentlemen, place your bets.

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