American Enterprise Institute for Public Policy Research

November 2006

Short Odds for Ignorance

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Legislation banning Internet gambling was signed by the president on October 13, 2006. The law has significant implications for the millions of Americans who gamble online. Less well understood is another consequence of the legislation: it could delay or halt the development of productive information markets on the web that operate by pooling the collective wisdom of savvy bettors in a wide variety of areas.

In late September, as Congress rushed to adjourn, lawmakers passed legislation that would make it a crime for credit card companies and banks to send payments to Internet gambling sites.

The measure was attached to an unrelated bill on port security at the eleventh hour. Now that the president has signed the legislation, it will have major implications for the millions of Americans who gamble online. It will also likely lead to a temporary halt in domestic online betting, which will result in billion-dollar losses for Internet gambling sites.

While these would be significant outcomes, they are probably not that important for the overall economy. Consumers will find other ways to spend their money, either in casinos or elsewhere.

The bigger economic story is how this act, by effectively prohibiting Internet betting, could unintentionally slow the emergence of new tools that have the potential to improve the productivity of the private sector and the government. Sadly, this is an aspect of the measure that both its supporters and its opponents seem to have overlooked.

Representative Jim Leach, an Iowa Republican who was a cosponsor of the bill, suggests that it will help reduce gambling addiction and money laundering. Not surprisingly, executives at online gambling companies argue that the bill unduly restricts consumer freedom.

What neither side has mentioned, however, is how the prohibition on Internet gambling could wind up putting the kibosh on several forms of Internet wagering that provide useful information.

For instance, we now have markets for predicting political and economic events, where you can wager on the monthly unemployment rate or the outcome of the presidential race. (If you visit TradeSports.com, you can bet on Hillary Clinton's chances of becoming the next president: a contract purchased for $1.91 would yield $10 if she wins, implying that the senator has about a one in five chance of winning.)

Why should we care? Because information markets, which essentially reflect the collective wisdom of savvy bettors, can help us make more accurate forecasts. Information markets have outperformed experts in a number of areas, whether it is predicting point spreads in football games or elections or printer sales. There are more than twenty websites that offer information market securities, including those run by Goldman Sachs and the University of Iowa.

These markets work for several reasons: First, almost anyone can participate. Second, people think hard when they have to back up their predictions with money; buy the right presidential

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contract and you win, buy the wrong one and you lose. Third, the profit motive encourages people to look for better information.

Premature Prohibition

Many academics across the political spectrum believe that information markets could be critical in improving decision-making by governments, non-profit organizations, and the private sector. Yet, because of current regulatory restrictions, the University of Iowa's market is the only one in the United States dedicated to improving our understanding of information markets. Also, those markets whose purpose is to make money have generally based themselves offshore, partly in reaction to existing state and federal restrictions on Internet gambling.

So what can be done? Congress needs to draw a distinction between run-of-the-mill Internet gambling and information markets that can serve a broader economic purpose. To this end, it should empower the Commodities Futures Trading Commission to regulate information markets. The commission is already charged with regulating futures contracts, and information market contracts can be thought of as futures contracts because they represent bets on what will happen down the road.

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Congress should also impose a requirement that information market contracts pass an economic purpose test. The futures commission should permit information market contracts that are likely to provide significant financial hedging opportunities or valuable information for improving economic decisions. Internet poker games and lotteries would not pass the test; contracts involving gross domestic product, housing starts, or expected annual rainfall would. So, too, would predictions on who will be president, as that would affect the economy.

For such regulation to work, it needs to be light-handed. To maximize innovation, Congress should allow for federal preemption of state and other federal regulatory authorities for information market contracts that pass an economic purpose test. Such preemption would reduce uncertainty for innovators concerned about violating state gambling laws.

The regulation should also allow for broad exemptions where sensible. One could, for example, introduce exemptions for research in which the size of individual investments does not exceed $1,000 per participant. The futures commission already has the power to encourage such research, but thus far it has only given its blessing to the University of Iowa's markets.

Congress has correctly pinpointed Internet gambling as an area deserving of further study and possibly legislation. But a blanket prohibition on such gambling is premature and likely to be counterproductive. Now that this prohibition is law, Congress should make sure that productive information markets are allowed to flourish.