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Correlation Does Not Imply Causation: An Econometric Perspective

Tara Prasad Bhusal

Professor, Central Department of Economics, Tribhuvan University, Nepal
Email: tarabhusal777@gmail.com
https://orcid.org/0009-0005-2260-6622

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Abstract

Purpose – The main aim of this paper is to clarify the distinctions between statistical correlation and causation, addressing the research question: How can researchers avoid misinterpreting correlations as causal relationships in empirical analysis?

Methods/Design-This theoretical paper reviews concepts from economics and econometrics, discussing pitfalls like spurious correlations, Simpson's paradox, and omitted variable bias. It examines causal identification methods, including randomized controlled trials (RCTs), quasi-experiments, instrumental variables (IV), and difference-in-differences (DiD), illustrated through examples from education, labor economics, healthcare, and macroeconomics.

Findings-Key pitfalls include spurious associations and biases that obscure true causality. Methods like RCTs and IV effectively isolate causal effects, as demonstrated in accessible case studies, revealing that correlations alone fail to establish cause-and-effects.

Conclusion/Implications-Rigorous causal inference, guided by theory and robust design, is vital for credible analysis. Implications include improved policy-making, business decisions, and academic rigor, urging greater emphasis on causal methods to prevent erroneous conclusions.

Limitations of the Study-As a conceptual review, it lacks original empirical data and may not cover all domain-specific nuances.

Originality of the Study-This work uniquely integrates diverse econometric tools with real-world examples across fields, distinguishing it from prior discussions by emphasizing practical application for non-specialists.

Keywords: *Correlation, Causation, Econometrics, Causal inference, Instrumental variables, Natural experiments, Pson's paradox*

Introduction

Correlation is a statistical measure that quantifies the degree of association between two or more variables. It indicates how strongly variables move together, but it does not describe the underlying mechanism or direction of influence. For instance, one might compute the correlation between household income and consumer spending to assess how closely their movements align. However, correlation does not describe patterns of consumption behavior, it only measures the strength and direction of a relationship within observed data (Akoglu, 2018; Wooldridge, 2020).

By definition, correlation captures association rather than causation. Yet, despite this distinction being fundamental to statistical reasoning, misinterpretations of correlation as evidence of causality remain common in research, media reporting, and policy discourse. Empirical studies and commentaries have shown that this misconception arises particularly in fields such as economics, epidemiology, and social policy, where observational data dominate (Aldrich, 1995; Freedman, 1999; Pearl, 2009; Vigen, 2015). In public communication of research, for example, correlations are often framed as causal claims , such as "eating chocolate improves intelligence" or "video games cause violence", even though the statistical evidence supports only an association. As Pearl (2009) argues, this confusion persists because traditional statistical models describe data dependence but not causal mechanisms, leaving many analysts to overinterpret associations as causes.

A classic example highlights this fallacy. Ice cream sales and drowning deaths both rise during the summer months. A superficial reading of this positive correlation might suggest that ice cream consumption causes drowning. In reality, both are driven by a third factor, temperature, which increases ice cream consumption and swimming activity, the latter elevating drowning risk. Statisticians emphasize the concept of conditional correlation precisely to address such issues: once the confusing factor (temperature) is controlled for, the correlation between ice cream sales and drowning deaths disappears (Akoglu, 2018; Freedman, 1999).

In economics, the implications of misinterpreting correlation as causation are far more consequential. Analysts routinely study correlated variables such as education and income, inflation and unemployment, or public spending and economic growth. Treating such correlations as proof of causation without rigorous testing can lead to flawed policy design and incorrect inference. For instance, a policymaker might attribute rising GDP solely to increased public expenditure, overlooking confounding influences such as global demand, technological change, or private investment cycles. Without identifying and controlling for these underlying factors, the estimated "effect" of public spending is merely an association, not a verified causal relationship (Angrist & Pischke, 2009; Wooldridge, 2020).

Accordingly, the purpose of this paper is to revisit the principle that "correlation does not imply causation" from an econometric perspective, clarifying the conceptual distinction between association and causation, reviewing how causal inference is established in practice, and illustrating the role of econometric tools in distinguishing spurious relationships from genuine causal effects

Methodology

The present article is grounded on the conceptual and methodological review. It surveys foundational and recent contributions from econometrics, applied economics, and related fields that examine the relationship between association and causation, with particular emphasis on materials that have been influential in applied work, including both classic studies and practitioner-oriented guides. The survey was conducted searching the keywords used included "correlation versus causation," "causal inference," "instrumental variables," "difference-in-differences," "randomized controlled trials," "Simpson's paradox," and "spurious correlation." Sources were drawn from the canonical literature (Rubin 1974; Pearl 2009), practitioner reviews (e.g., Baker et al., Becker & Aleksin), referred articles and influential working papers, as well as accessible expositions addressing common misinterpretations (Hershbein 2015; Vigen 2015). Snowballing from key papers identified additional empirical examples and methodological debates. The review synthesizes conceptual frameworks (potential outcomes, structural causal models), identification strategies, and illustrative empirical examples.

This paper examines the theoretical foundations of correlation and causation, explores econometric challenges, and discusses strategies for credible causal inference.

Distinguishing Correlation and Causation

Correlation (association) is a statistical measure describing co-movement between variables. Multiple types of association exist (linear correlation, rank correlation, conditional correlation). Association is a statement about joint distribution, not about mechanism or direction. Whereas causation is a statement that intervening on (or changing) one variable produces a change in another variable. Formal frameworks like the Rubin causal model (potential outcomes) and Pearl's structural causal models (SCMs), formalize interventions and the assumptions needed to infer causal effects from data (Rubin, 1974; Pearl, 2009).

Correlation quantifies the degree to which two variables move together, often measured using Pearson's correlation coefficient. Values range from negative one, indicating perfect inverse correlations, to positive one, indicating perfect direct correlations. However, even a correlation coefficient of one does not imply that changes in one variable cause changes in another. For instance, an observed positive correlation between the number of hospitals in a city and total healthcare expenditure may suggest causality. However, the true underlying factor may be population size: more populous cities require more hospitals and simultaneously incur higher healthcare costs. This example highlights the risk of inferring causation from correlation without careful consideration of underlying mechanisms.

Causation implies a directional, mechanistic relationship in which changes in an independent variable directly induce changes in a dependent variable. Economists formalize this distinction through frameworks such as the potential outcomes model proposed by Rubin (1974) and structural causal models developed by Pearl (2009). These frameworks make explicit the assumptions required to identify causal effects, providing a formal basis for moving beyond mere correlation.

Spurious correlations illustrate the risks inherent in naïve interpretations of data. A well-known non-economic example is the apparent positive correlation between stork populations and human birth rates in rural Europe — a relationship once humorously cited as evidence that "storks bring babies." In reality, the correlation arises from a common cause: rural population density. Areas with more rural households both host more storks (due to open farmland and chimneys) and record higher birth rates than urban regions, thereby producing a misleading statistical association without any causal mechanism (Vigen, 2015).

In economics, spurious correlations often result from omitted-variable bias or simultaneous causality. For example, during periods of economic expansion, both investment in education and private consumption tend to rise. A naïve analyst might infer that higher education investment causes greater consumption, but both are actually driven by an omitted factor like aggregate income growth. Rising income simultaneously enables households to spend more on consumption and governments or individuals to invest more in education. The true causal driver is therefore the expansion of income, not the direct interaction between education investment and consumption.

This example underscores how failing to control underlying macroeconomic variables can lead to misconceived causal interpretations. The association between education spending and consumption is genuine in the data but only reflects joint movement due to a third factor (income growth) rather than a causal influence of one variable on the other. Proper econometric modeling, for instance, using multiple regression or instrumental-variable approaches — is necessary to isolate and test causal channels once such confounders are recognized (Wooldridge, 2020; Angrist & Pischke, 2009).

Simpson's paradox further illustrates how misleading correlations can emerge from aggregated data, obscuring or even reversing the true relationships observed within subgroups. The paradox occurs when a trend present in several disaggregated groups disappears or reverses when the data are combined. The classic example is the 1973 University of California, Berkeley graduate admissions case, analyzed by Bickel, Hammel, and O'Connell (1975). At the aggregate level, admissions data showed that men had a significantly higher acceptance rate than women, seemingly indicating gender bias. However, when the data were broken down by department, the pattern reversed: within most departments, women actually had the same or higher acceptance rates than men.

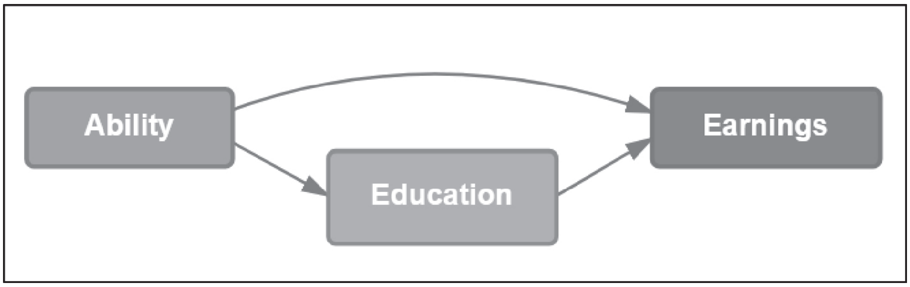
The apparent gender bias was therefore a spurious correlation caused by omitted-variable bias, in this case, the omitted variable was the competitiveness of the departments to which applicants applied. Women tended to apply to departments with lower overall acceptance rates (such as humanities and social sciences), while men more often applied to departments with higher acceptance rates (like engineering or sciences). When this underlying factor was controlled for, the supposed gender discrimination vanished. This case exemplifies how correlation is not causation: the aggregate correlation between gender and admission outcomes suggested a causal relationship (gender bias), but the true cause of the disparity was the composition of applications across departments. Without disaggregating or controlling for confounding variables, correlations in aggregated data can lead researchers to incorrect causal conclusions, a critical lesson for empirical work in economics, where subgroup heterogeneity is common in wage studies, educational attainment, and poverty analyses.

Omitted-variable bias and endogeneity are central econometric issues that explain why correlation does not imply causation. Both occur when the observed association between variables is contaminated by unaccounted-for factors, leading to misleading causal interpretations. While correlation simply measures the degree to which two variables move together, it does not control for other influences. Regression analysis attempts to isolate the effect of one variable while holding others constant, but when relevant factors are omitted or correlated with included variables, the estimated relationships remain biased.

A classic example involves the relationship between education and earnings. A simple correlation or even a basic regression may show a strong positive association between years of schooling and income. However, this observed correlation could be spurious if driven by unobserved variables such as innate ability, motivation, or family socioeconomic background, factors that simultaneously affect both education attainment and earnings potential. In such cases, the estimated effect of education on income is endogenous, meaning that education is correlated with the error term in the regression equation. The result is that the estimated coefficient overstates (or sometimes understates) the true causal effect of education because part of what appears to be the "effect of schooling" actually reflects these omitted influences.

This example underscores that correlation, even one produced through regression, cannot by itself establish causation without addressing endogeneity. Economists use tools like directed acyclic graphs (DAGs) to map potential causal paths and identify confounding variables and apply econometric techniques such as instrumental variables (IV) or randomized controlled trials (RCTs) to obtain exogenous variation. By doing so, they aim to separate genuine causal effects from mere statistical association. Thus, the presence of omitted-variable bias or endogeneity directly illustrates the maxim that correlation is not causation: observed relationships in data can mimic causal links unless the underlying structure and sources of variation are rigorously analyzed (Wooldridge, 2020; Angrist & Pischke, 2009; Becker & Aleksin, 2024).

Figure 1: Directed Acyclic Graph (DAG) – Education, Ability, and Earnings



Source: Auther's own work

Figure 1 is about the Directed Acyclic Graph (DAG) illustrating the causal relationships between ability, education, and earnings. Ability confounds the relationship between education and earnings, highlighting the need for methods such as instrumental variables or natural experiments to identify causal effects. The DAG clarifies why simple regression of earnings on education without controlling for ability yields biased estimates. This DAG visualizes the causal relationships between innate ability, education, and earnings. An arrow points from Ability to Education, representing that more capable individuals may pursue more schooling. Another arrow points from Ability to Earnings, showing that ability directly influences earnings. Finally, Education points to Earnings, representing the potential causal effect of education on earnings.

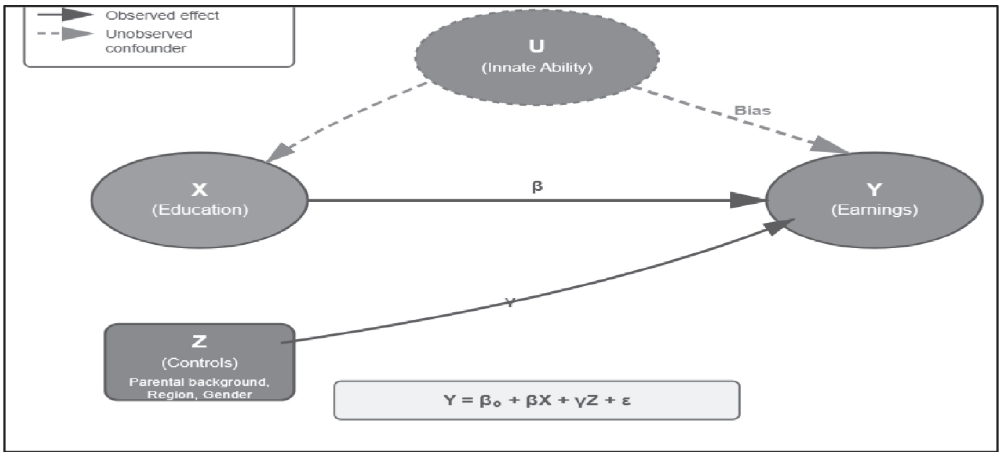
Econometric Approaches to Causal Inference

Given the limitations of correlation, economists have developed methods to isolate causal effects. Randomized controlled trials (RCTs) represent the gold standard, where subjects are randomly assigned to treatment or control groups. Randomization balances both observed and unobserved confounders, allowing differences in outcomes to be attributed causally to the treatment. Although common in medicine and behavioral sciences, RCTs are often impractical in macroeconomic or large-scale policy settings.

When randomization is infeasible, quasi-experimental designs exploit naturally occurring variations to infer causal effects. Among these, instrumental variables (IV) and difference-in-differences (DiD) are two widely used approaches. The IV method relies on a variable, the instrument, that influences the treatment but affects the outcome only through that treatment. A well-known example is the use of changes in compulsory schooling laws as instruments to identify the causal effect of education on earnings. By focusing on individuals whose schooling decisions are influenced by the reform, researchers can estimate the causal impact of education while mitigating confounding from unobserved factors such as innate ability or family background (Angrist & Krueger, 1991; Becker & Aleksin, 2024).

Similarly, the difference-in-differences (DiD) approach compares changes in outcomes over time between a treatment group exposed to a policy intervention and a control group that is not. This method isolates causal effects under the assumption that, absent the intervention, both groups would have followed parallel trends (Card & Krueger, 1994; Baker et al., 2025). Both IV and DiD serve as powerful tools for distinguishing causal effects from mere correlations in non-experimental settings.

Figure 2: Conceptual Regression Schematic



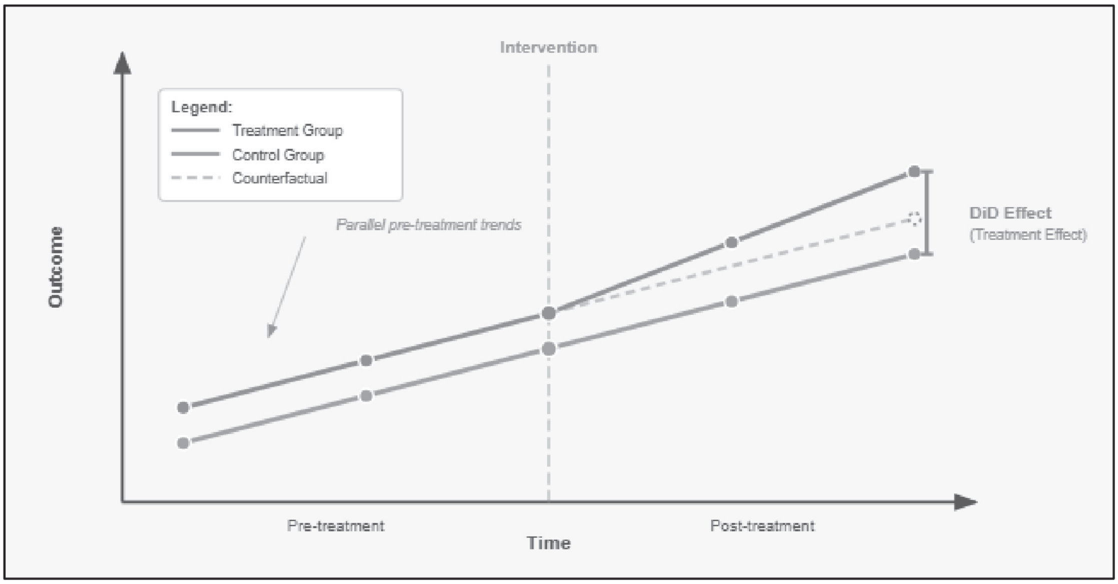
Source: Auther's own work

Figure 2 shows the conceptual regression schematic depicting earnings (Y) regressed on education (X) and observed controls (Z). Dashed arrows indicate unobserved confounders (U) that bias estimates if not accounted for through methods such as instrumental variables or natural experiments. It visually emphasizes how controlling observed variables mitigates but may not eliminate bias from unobserved confounders. Imagine a standard regression setup: earnings (Y) is regressed on education (X), with controls (Z) such as parental background, region, and gender. A schematic can show arrows from X and Z to Y. A dashed arrow from unobserved confounder (U, e.g., innate ability) to Y represents the source of bias in OLS estimation.

Difference-in-differences designs compare changes in outcomes over time between treatment and control groups. Assuming that the groups would have followed parallel trends in the absence of the intervention, any divergence in outcomes after the intervention can be attributed to the treatment effect. DiD is particularly useful in policy evaluation, such as assessing the impact of tax reforms or labor market regulations on employment and wages.

Figure 3 gives the Difference-in-differences (DiD) conceptual illustration. Parallel pre-treatment trends between treatment and control groups allow the post-treatment divergence to be interpreted as the causal effect of the intervention. A line chart showing outcomes over time for a treatment and a control group. The pre-treatment trends are parallel. After the intervention, the treatment group diverges upward relative to the control. The vertical distance between the post-treatment points (adjusted for pre-treatment differences) represents the DiD estimate of the treatment effect.

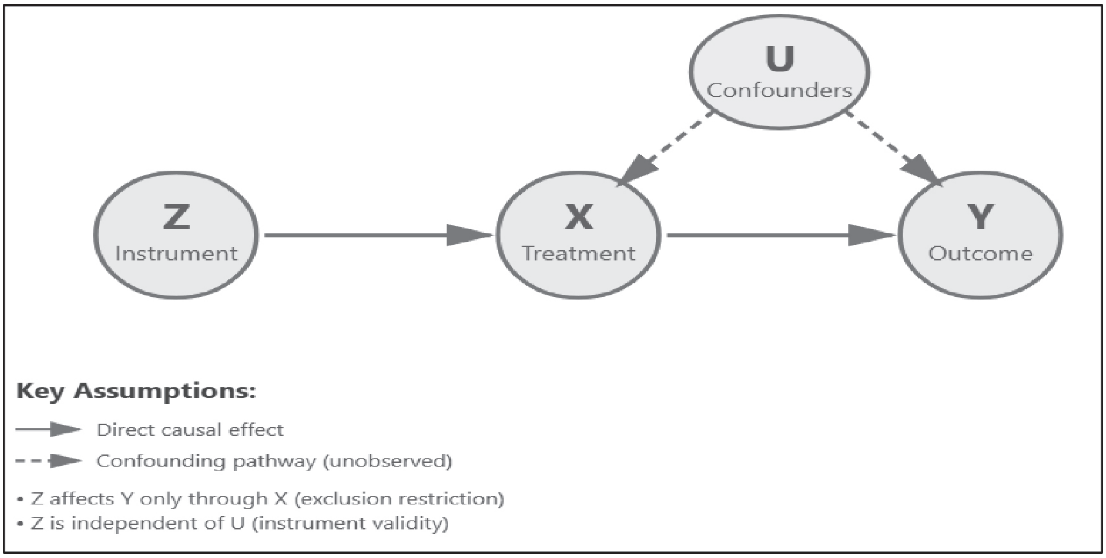
Figure 3: Difference-in-Differences (DiD) Conceptual Illustration



Source: Author's adaptation based on standard presentations of the DiD model (see Angrist & Pischke, 2009; Baker et al., 2025).

Regression methods with covariate controls and matching techniques also attempt to estimate causal effects. By including observable covariates or matching treated and untreated units on pre-treatment characteristics, researchers aim to approximate randomized conditions. However, these methods rely on the assumption that all relevant confounders are observed, which is often unrealistic. Therefore, while useful, such approaches may still yield biased causal estimates if key confounders are unmeasured.

Figure 4: Instrumental Variable (IV) Conceptual Diagram



Source: Auther's own work

In Figure 4, the instrument (Z) affects the treatment (X) while bypassing unobserved confounders (U), allowing identification of the causal effect of X on the outcome (Y). It shows that the instrument (Z) affecting the treatment (X) but influencing the outcome (Y) only indirectly. The diagram has a direct arrow from Z to X, and from X to Y. A dashed arrow indicates potential confounders (U) affecting both X and Y, which IV aims to bypass.

Illustrative Applications

A prominent example in labor economics involves the returns to education. Ordinary least squares regression often shows a wage increase of approximately 10% per additional year of schooling. However, this estimate conflicts with unobserved ability. Instrumental variable approaches, using reforms in compulsory schooling as instruments, produce more credible estimates of around 3% per additional year, reflecting a causal effect rather than simple correlation (Becker & Aleksin, 2024).

In health economics, correlations between healthcare spending and outcomes may reflect underlying socioeconomic status or access to facilities rather than causal effects of expenditure. Quasi-experimental methods, such as staggered implementation of health policies, help isolate the causal impact of interventions on health outcomes.

Macroeconomic analyses also illustrate the limits of correlation. Stock market performance and GDP growth often display positive correlations. However, causality may run in either direction, or both variables may respond to a third factor, such as monetary policy. Structural models and Granger causality tests can help disentangle these relationships, but causal interpretation remains contingent on model assumptions.

Conceptual illustrations such as Directed Acyclic Graphs (DAGs) and regression schematics remain valuable pedagogical tools for clarifying causal reasoning. Although DAG-based thinking originated in structural equation modeling (SEM) in the 1950s and has been formalized in econometrics and social sciences for decades, its continued relevance lies in helping researchers visualize why correlation does not imply causation. A simple DAG representing the relationship among education, ability, and earnings would depict arrows from ability to both education and earnings, highlighting the confounding pathway that biases the observed correlation between schooling and income. Recognizing and "blocking" such backdoor paths—for example, through the use of instrumental variables or natural experiments—illustrates how researchers can move from association to causal inference.

In this paper, these conceptual diagrams are not presented as new methodological contributions but as didactic devices for students and emerging researchers to better understand how causal reasoning can be integrated into regression-based empirical analysis. The intention is to synthesize existing theoretical and methodological insights rather than to introduce new empirical findings. By illustrating well-established econometric principles in accessible form, the paper reinforces how traditional regression approaches must be complemented by explicit causal frameworks to correctly interpret relationships in social-science data.

Conclusion

Correlation is simply a statistical measure of association—most often linear—between two or more variables. It indicates the degree to which variables move together but says nothing about why they do so. It is, therefore, neither a necessary nor a sufficient condition for causation. Causation concerns the directional and mechanistic relationship between variables – specifically, whether and how changes in one variable generate changes in another, holding all the other factors constant. While correlation can serve as a preliminary indicator that two variables are related, it does not, by itself, establish that one causes the other.

The fundamental distinction is that correlation is descriptive, whereas causation is explanatory and theory driven. Regression analysis, particularly when based on sound theoretical reasoning—extends beyond correlation by incorporating control variables and confounding factors, allowing researchers to estimate conditional relationships that are more consistent with causal mechanisms. Moreover, regression models can accommodate nonlinear and multivariate relationships, far beyond the scope of simple (bivariate) correlation. Yet, even regression-based estimates can be misleading when key variables are omitted or when endogeneity persists; hence, causal identification requires more than statistical modeling—it requires conceptual clarity and theoretical grounding.

A credible causal study must rest on a strong theoretical framework that identifies which variables are exogenous and how they are expected to influence the dependent variable. Sound econometric practice complements this with rigorous empirical designs, such as randomized controlled trials (RCTs), quasi-experiments, instrumental variables (IV), and difference-in-differences (DiD) methods, to address the limitations of mere statistical association. Likewise, visual causal models, such as Directed Acyclic Graphs (DAGs), help clarify assumptions about causal pathways and confounding influences, but their interpretation must always be guided by theory rather than data patterns alone.

In essence, correlation provides a first-hand, exploratory benchmark for linear association, while causal inference, through regression and identification strategies, builds on theoretical reasoning to uncover cause-effect relationships. Recognizing this hierarchy is crucial: theory determines which variables are treated as independent or dependent, while econometric methods provide the empirical tools to test those theoretical propositions. It cautions researchers and policymakers to move beyond surface-level associations, applying theory-informed models and credible identification techniques to uncover genuine causal mechanisms within complex social and economic systems.

Implications for Research and Policy

Misinterpreting correlations as causal can have severe consequences for economic policy, corporate strategy, and social interventions. Policies based solely on correlated trends may fail or produce unintended side effects. Researchers and policymakers must carefully articulate assumptions, use robust identification strategies, and conduct sensitivity analyses to assess the robustness of causal claims.
While correlation is insufficient to establish causation, it remains valuable for generating hypotheses and guiding further inquiry. A strong correlation may indicate a causal relationship worth investigating, but it must be tested rigorously before informing policy or scientific conclusions.

Scope for Future Research

We can build on this work by linking basic econometrics to new tools like AI. Machine learning could spot hidden links in causal maps faster than we do by hand. This would clean up huge data sets in fast-growing areas like digital trade or eco-friendly rules. We should also test methods like difference-in-differences on fresh data from real crises, such as COVID responses. These steps would show if our tools work well in tough spots and give better tips to leaders.

Conflicting Issues

The paper sticks to clear theory and easy examples, so the analysis types cause no real conflicts. We avoid hot debates by focusing on basics like RCTs and IV without pushing one over the other. This keeps things steady and fair for readers.

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