

Abstract

This article analyzes the effect of personal income taxation on the pay-to-stock-price sensitivity of executive compensation contracts generated by stock option and restricted stock grants. Using Execucomp data for 1992–1996 and variation in the ordinary income marginal tax rate of top earners in the same time period, I find that an increase in the tax rate decreases the pre-tax pay-to-performance sensitivity generated by option grants, whereas stock grant sensitivity is found to be unresponsive to the same change. Even though these results can be explained by joint tax optimization of executives and their employers, they suggest that after-tax incentive provision for executives is quite sensitive to variation in the ordinary income tax rate.

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