Internal sources for financing innovation

Internal sources of finance are critical for firms' innovation activities. This includes notably retained earnings, the profits accumulated over time which have not been returned to shareholders. Firms often use internal financing rather than external financing.

Several factors shape firms’ decisions to allocate their own resources to financing innovation:

- Sources as diverse as money and capital provided by family and friends to start a business are available. Corporate management may then use these resources to invest in innovative businesses.

- Large firms with multiple divisions can fund their innovation investments in one division given the presence of other businesses. This is particularly critical in this context (see Resource allocation mechanisms within firms [5]).

- The same firm may finance an innovation project that is not necessarily beneficial to the firm. This can be good if it leads to profitable investment that would not happen otherwise.

- Moreover, the competitive environment can impact how many internal resources are available for innovation. Firms can recoup the fixed cost of investing in innovation by selling the resulting product at a price that is higher than the marginal cost of producing it.

Finally, while having access to internal resources facilitates investment in innovation by avoiding many of the challenges that arise for firms as they seek external sources of finance [8], it also makes it easier to undertake potentially unproductive investments. Not being required to convince external providers of finance gives managers the freedom to use their firms’ retained earning with high discretionality. This can be good if it leads to profitable investment that would not happen otherwise, but bad if CEOs spend these funds on activities that are beneficial to them rather than to maximize long-term shareholder value.

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