Mike Spence writes: Chinese President Xi Jinping's massive anti-corruption campaign has advanced a number of key objectives: It has gone a long way toward restoring confidence in the Communist Party's commitment to a merit-based system; countered a decades-old pattern of public-sector domination; reduced the power of vested interests to block reform; and bolstered Xi's popularity among private-sector actors, if far less so with the bureaucracy.

In short, Xi's effort to root out corruption has empowered both the Party and the reformers. The question is how far they will take their reform ambitions. Xi is certainly not finished yet, having outlined a set of legal reforms at last month's Fourth Plenum of the Communist Party aimed at creating a more level playing field for the public and private sectors. If implemented properly, the reforms will create a more efficient system for the creation and enforcement of contracts, ease the path for market entrants, and strengthen the application of China's competition laws.

Greater fidelity to the rule of law will also lead to the creation of a legal and financial infrastructure that reduces fraud in the private sector, including in financial reporting. That, together with increased access to capital, will help to accelerate the development of the services sector, which is needed to create urban employment. Better management of China's considerable public assets – which include $3.5-4 trillion of foreign-exchange reserves, substantial land holdings, and majority ownership of the state-owned enterprises that dominate the economy – would complement these efforts. Indeed, it could help to boost competition, encourage innovation, strengthen the financial system, and expand access to capital.

The question is how China could achieve this. As it stands, China's economy follows, to some extent, the old Leninist "commanding heights" model, with the Party holding all political power and controlling major enterprises and sectors, even as the burgeoning private sector drives growth and employment. In this context, the kind of "meritocratic professionalism" that China is pursuing is important; but it is no substitute for genuine competition in the public or private sector – at least not if innovation and structural change are the goals.

Will Xi could simply declare that China's version of state capitalism has worked well in the past, and will continue to do so. But experience with the microeconomic dynamics of advanced economies (where China is headed) makes this a weak stance – and, thus, one that Xi is unlikely to take.

The alternative would be to embark on a sustained program of privatization to shrink the asset side of the state's huge balance sheet. But China's balance sheet has served it well, enabling the extraordinarily high rates of investment that have fueled rapid growth. Meanwhile, many advanced economies have suffered considerably from their balance-sheet composition, with limited, poorly measured assets and outsize debt and non-debt liabilities.

In fact, given an increasingly unequal distribution of income between capital and labor (as well as across the income spectrum for labor) a larger store of public assets certainly has merit, as it equalizes the distribution of capital and wealth, albeit indirectly. Not only can public assets be used to cushion shocks and counter adverse trends; they can also help fund an expansion of social insurance.

The problem in China is not the volume of state-owned assets, but their concentration in a few companies and industries – a situation that poses risks to economic performance. Given this, the logical solution is not to dispose of the state's asset holdings, but to diversify them over time.

Such an approach would have a number of benefits. First and foremost, it would reconcile a large state balance sheet with an expanding role for markets, bolstering employment, stimulating innovation, and advancing the economy's structural transformation. To this end, public investment in infrastructure, human capital, and the economy's knowledge and technology base would remain crucial.

Furthermore, the diversification of China's asset holdings would deepen its financial markets considerably. Over the next several years, as the traded or tradable share of the state-owned sector's market capitalization increased from today's low base of 10-15%, more institutional investors, such as pension funds and insurance companies, would become involved in Chinese equity trading, which is currently dominated by retail investors. This would augment savings options for an increasingly affluent population and strengthen support for long-term investment and development.

Debt markets would also benefit from such an initiative. Blurring the line between the private and the state-owned sectors would, over time, reduce the latter's privileged access to – and overuse of – bank financing, leading to the expansion of corporate bond markets. With public entities like the social security system and sovereign-wealth funds holding more diversified asset portfolios, incentives would be substantially reduced for market intervention favoring incumbents in which the state owned a large share. This, along with enhanced enforcement of competition law, would go a long way toward leveling the playing field in markets.

Clearly specified fiduciary responsibilities and governance would help to ensure that publicly held assets were managed to maximize long-term risk-adjusted returns, with the state and citizens as beneficiaries and the market as the arbiter of efficiency and innovation. The best-managed state-owned enterprises could emerge – or remain – as successful and prominent players, adapting to expanded market competition and combining innovation with economies of scale.

Indeed, public-sector asset management could be "outsourced," with private asset managers competing for the job. This would accelerate the development of the asset-management sector, with far-reaching benefits for savers and investors.

China does not have to give up the safety net provided by large asset holdings to allow markets to play a decisive microeconomic role. It can abandon the commanding heights model and develop its version of "state capitalism" to support the best of both worlds. All that is needed is a persistently strong government commitment to the public interest – and, of course, a skillfully executed reform strategy.