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Welcome to the Virgin Islands, One of the Most Indebted Places in the U.S.

The U.S. territory is running out of options as it faces rising debt and pension obligations, a declining population and tepid response to proposed new bond offerings

A U.S. territory famed for its white-sand beaches and azure waters is in a precarious financial position. This time, it isn't just Puerto Rico.

The U.S. Virgin Islands shares many of the same fiscal problems as its Caribbean neighbor 80 miles to the west: high levels of debt, mounting pension obligations and a declining population.

Local legislators on Tuesday are expected to consider a new round of taxes as a way to shore up the Virgin Islands' $110 million budget deficit. That follows an unsuccessful attempt this month to sell about $220 million in bonds, the second time in two months the territory has called off a planned bond sale.

Virgin Islands Gov. Kenneth Mapp said the territory, with a population of some 105,000 people, has no problems making payments on its $2.2 billion in debt obligations. But he predicted widespread service cuts and layoffs if new bonds can't be sold.

Moody's Investors Service on Tuesday downgraded certain Virgin Islands bonds by three notches further into junk and cited "an increased possibility that the government may be forced to restructure its debt to address its financial problems."

"I think this is a critical juncture," said Nikolao Pula, director of the Office of Insular Affairs, which coordinates federal policy for several U.S. territories as part of the Interior Department. "We just hope whatever decision they make will be good moving forward."

Any failure by the Virgin Islands to pay back money owed to investors could intensify competition for limited government dollars inside the territory.

Virgin Islands bonds have traditionally appealed to mainland bondholders and U.S. mutual funds because they are exempt from state taxes. U.S. mutual funds hold nearly $1 billion in Virgin Islands bonds, according to research firm Morningstar Inc.

The mutual fund with the highest percentage of its portfolio invested in Virgin Islands debt is made up largely of Wisconsin investors. Wells Fargo Asset Management, which oversees the Wells Fargo Wisconsin Tax Free C fund, said it is protecting itself from the Virgin Islands' financial situation by holding debt that is either insured or coming due within the next 18 months. More than 8% of its holdings is debt issued by the U.S. territory.

At Western Asset Management, based in Pasadena, Calif., which also holds Virgin Islands bonds, senior analyst Fred Poon said he expects the Virgin Islands legislature will eventually enact a "sin tax" on cigarettes and alcohol, as well as other revenue-raising measures.

“Who wants to argue against taxes on sin?” Mr. Poon said.

Including the islands of St. Thomas, St. John and St. Croix, the Virgin Islands has long struggled with budget deficits, but its problems accelerated after the 2008 economic downturn.

First, the economy, long dependent on tourism, took a hit. Annual expenditures by visitors fell 19% in the period from 2007 to 2013, a drop of $280 million. The territory’s population shrank by almost 9% over that period.

Another blow came in 2012 when one of the territory’s biggest employers shut down. The Hovensa oil refinery on the island of St. Croix employed 1,200 workers and 960 contractors, according to a report by Fitch Ratings at the time. The closing was expected to deprive the government of an estimated $100 million in annual revenue, according to a 2012 report from the then-governor.

With less revenue, the territory has relied increasingly on bond proceeds to pay operating costs while contributing less to pension plans. That borrowing has increased its debt to a level similar to that of Puerto Rico, on a per capita basis.

The lower pension contributions widened the funding gap for a retirement system that covers 9,303 current workers and 8,465 retirees and past workers, according to the fund’s 2015 financial reports.

That pension plan has only 27% of what it needs to pay future benefits, according to 2015 financial statements; a 2015 analysis by Segal Consulting predicted the fund would run out of money by 2024.

The governor said he plans to unveil proposed pension fixes this year and hold hearings on the topic. “We need to come up with a strategy,” Mr. Mapp said.

Another strain is that U.S. territories, including the Virgin Islands, typically receive less federal money than U.S. states, according to Rep. Stacey Plaskett, the nonvoting U.S. congresswoman representing the Virgin Islands. For example, the federal government caps the amount of Medicaid payments the territories receive. “Our disparity of treatment is I believe what has caused these financial issues to occur,” Rep. Plaskett said.

Some analysts expect the territory to eventually turn to Washington, D.C., for help, as Puerto Rico did in 2016. Congress last year passed legislation that provides Puerto Rico with a stay against creditor litigation in exchange for oversight from a seven-member board that controls the territory’s finances and approves any court-supervised debt restructuring.

A similar solution for the Virgin Islands “is totally possible within the next five years,” said Matt Fabian, a partner with research firm Municipal Market Analytics.

But a cash crunch could come much sooner. Ken Kurtz of Moody’s predicts the territory will need to sell bonds within the next few months to keep from running out of operating cash.

Interest in Virgin Islands bonds has been scarce ever since Congress authorized debt-relief legislation for Puerto Rico last June. Bondholders showed lukewarm interest in a Jan. 11 offering, even after the governor requested that federal funds backing the bonds be wired directly to an escrow agent, to alleviate concerns that the Virgin Islands would divert the money if the financial situation worsens.

The Virgin Islands Public Finance Authority received orders for slightly more than 60% of the bonds after offering an interest rate “in the 6% range,” according to Mr. Mapp. The authority opted to cancel the deal rather than reduce its size, he said. A spokesman for the authority said it is no longer trying to sell bonds and will assess whether to re-enter the market “when appropriate credit and acceptable interest rates are present.”

About $55 million of the $219 million offering would have been used to close a gap in this year’s $1.35 billion budget, the governor said. If the Virgin Islands can’t close that gap, “this is not sustainable,” Mr. Mapp said. “We can’t continue doing this.”

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